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Management Packages after LBOs – Incentives and Value Creation

By

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Abstract

This study adopts a "mixed research methods" approach in order to try to identify the most common management incentive packages (**MIP**) and mechanisms used in companies under leveraged buyout (**LBO**), namely in France, and what other non-pay related factors influence the motivational effects of these MIPs and ultimately the value creation expected from the LBO. It quantitatively analyses data – obtained from the sponsoring investment bank – on French companies currently under LBO and uses the findings to design questions for semi-structured interviews conducted with sources having vast experience in Mergers and Acquisitions (**M&A**) and Private Equity (**PE**). It is the analysis of this qualitative data using axial coding and subsequent discussion that compose this study's main findings, as the often-undervalued management motivation aspects are extremely important to understand this vastly understudied topic.

Sweet Equity and **Ratchet Share** appear to be the most used mechanisms and the study concludes that taxation is a key factor taken into consideration when designing MIPs, as these tend to revolve around "tax-effectiveness" and appear to be the lead cause of MIP differences between countries and over the years.

Other aspects that are vital to ensuring the success of the MIP are its flexibility in the event of negative, exogenous events and the trust and alignment of interests between the management team and the PE fund. The research concludes that these can be ensured by having PE actively involved on the companies' boards and by having three anti-dilution measures – described as "The Holy Trinity" – put in place before the LBO is executed.

Acknowledgements

"Live as if you were to die tomorrow. Learn as if you were to live forever." - **Mahatma Gandhi**

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List of Acronyms, Abbreviations & Symbols

$	US Dollars
£	GB Pounds
€	Euros
CAPEX	Capital Expenditure
CCR	Cash-on-Cash Return
DD	Due Diligence
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation
EqV	Equity Value
EV	Enterprise Value
FRI	Fixed-Rate Instruments
GM	General Manager
IPO	Initial Public Offering
IRR	Internal Rate of Return
JBE	JB Equity
JV	Joint Venture
KPI	Key Performance Indicators
LBO	Leveraged Buyout
LTIP	Long-Term Incentive Plan
M&A	Mergers & Acquisitions
MBI	Management Buy-In
MBO	Management Buyout
MIP	Management Incentive Packages
MM&A	Messier, Maris & Associés
NPV	Net Present Value
PE	Private Equity
PPE	Plant, Property & Equipment
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
RSM	Ratchet Share Mechanism
Thin Cap	Thin Capitalisation
VC	Venture Capital

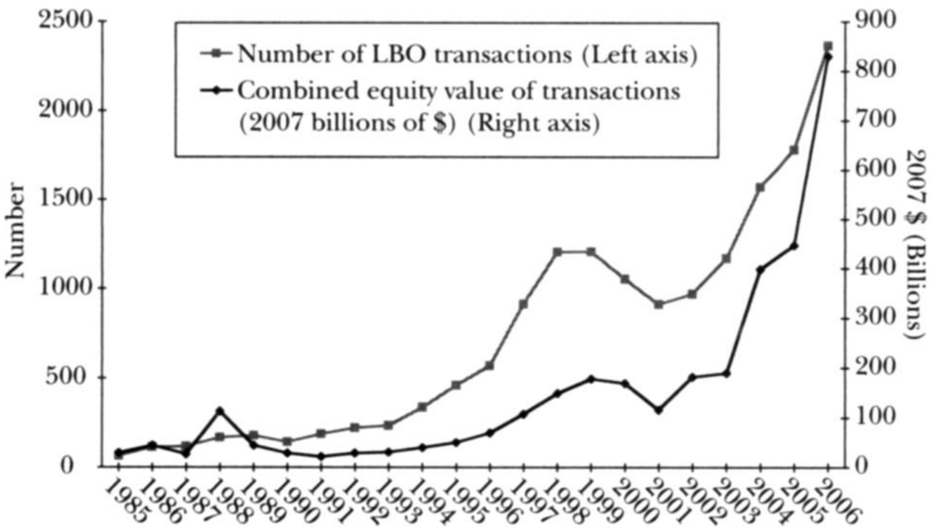
1. Introduction

This chapter will attempt to place into context the purpose and relevance of this study to Academia. It is broken down into three parts; the first will look at the nature of the problem and briefly describe LBOs, their history and recent evolutions, namely in what concerns the alternative management incentive packages. The second will address its relevance and the importance of further study in this field. Lastly, it will explain how this study articulates within the existing literature, in order to attempt to fill what appears to be a gap in the particular area of LBO-related executive compensation.

1.1. Nature of the Problem

In the 1980s, we saw the emergence and drastic rise in the level of leveraged buyout (LBO) deals, primarily carried out by private equity (PE) firms (Figure 1.1). This method allows PE firms to acquire companies (targets) through a "special purpose" holding company, without having to raise equity to cover the total purchase price as part of the deal is financed by taking on debt using the target company's assets as collateral. Normally the level of equity in these deals is around 20-40% (Olsen, 2012), although in recent years this has raised to 40-50% (Vernimmen, Quiry and Fur, 2014, p.843).

Figure 1.1 – Global Private Equity Transaction Volume, 1985-2006

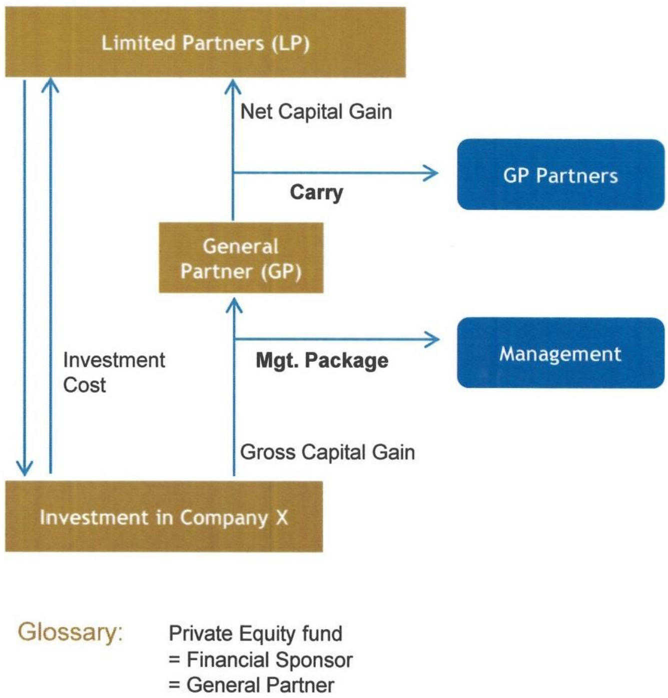


(Kaplan and Strömberg, 2009)

In the early days, LBOs were primarily carried out to purchase companies that were undervalued (in the stock market) in terms of the value of their net assets, such as property, plant and equipment (PPE), and then sell them off in pieces in a process known as "asset stripping", generally resulting in massive layoffs and huge debts. These transactions were carried out by individuals or companies, denominated "corporate raiders", and are one of the main reasons for the negative connotation associated with LBOs (Olsen, 2012).

In recent years, the main *modus operandi* of PE firms (general partner) is to set-up a closed-end[1] private equity fund and invite investors (limited partners) to supply most of the capital, with the general partner normally bringing in at least 1% of total funding (Kaplan and Strömberg, 2009). The capital is then used to invest in various companies – using diversification to mitigate risk – and to pay fund management fees. Once enough capital is raised, PE firms will select target companies and normally spend up to 5 years investing the fund's capital. In the meantime, the PEs might open other funds and invite new investors. Such funds have a fixed lifetime, normally 10 to 13 years, after which the initial investment is paid back to the investors, together with their share in the hopefully generated profits, or deducted of eventual losses. A fixed percentage of profits known as "carried interest"/"carry", which varies among PEs but normally amounts to around 20%, is kept by the PE firm (Olsen, 2012).

Figure 1.2 – Private Equity Industry in a nutshell



(Confidential Source, 2011)

[1] Meaning that the investors cannot "cash-out" until the fund is terminated.

After acquiring the target company, the PE then endeavours to increase its overall operational efficiency, namely its free cash flows, in order to pay back the debt and to reach a rate of return of 25-30% on exit, normally after 2 to 7 years (ibid.).

There are various types of exit strategies that can be used by the acquiring entity, ranging from declaring bankruptcy (of the remaining, empty shell), to bringing the company public through an initial public offering (IPO). Figure 1.3 illustrates how the use of these different exit strategies has varied over time. IPOs were initially one of the most common exit strategies, but have decreased over the years; most recent exit strategies have been the sale of the company to a strategic buyer. Strategies such as "secondary buyouts[2]" and, more recently the "sale to LBO-backed firms", have also emerged. Inevitably, due to the high level of debt incurred, some of these transactions will end in bankruptcy (6% of studies cases) as the operating cash flows are insufficient to repay the debts, and the debtholders and shareholders are unable to agree on its restructuration or the issuance of new equity, with the resulting write-off for debtholders and dilution for existing shareholders.

Figure 1.3 – LBO exit strategies over time

Year of original LBO	*1970–1984*	*1985–1989*	*1990–1994*	*1995–1999*	*2000–2002*	*2003–2005*	*2006–2007*	*Whole period*
Type of exit:								
Bankruptcy	7%	6%	5%	8%	6%	3%	3%	6%
IPO	28%	25%	23%	11%	9%	11%	1%	14%
Sold to strategic buyer	31%	35%	38%	40%	37%	40%	35%	38%
Secondary buyout	5%	13%	17%	23%	31%	31%	17%	24%
Sold to LBO-backed firm	2%	3%	3%	5%	6%	7%	19%	5%
Sold to management	1%	1%	1%	2%	2%	1%	1%	1%
Other/unknown	26%	18%	12%	11%	10%	7%	24%	11%
No exit by Nov. 2007	3%	5%	9%	27%	43%	74%	98%	54%
% of deals exited within								
24 months (2 years)	14%	12%	14%	13%	9%	13%		12%
60 months (5 years)	47%	40%	53%	41%	40%			42%
72 months (6 years)	53%	48%	63%	49%	49%			51%
84 months (7 years)	61%	58%	70%	56%	55%			58%
120 months (10 years)	70%	75%	82%	73%				76%

(Kaplan and Strömberg, 2009)

[2] This is when the company is sold to another financial investor, such as an investment fund, who sets up another LBO to do so.

Although in their study Kaplan and Strömberg (2009) point out that, based on their data illustrated in Figure 1.3, there is no evidence of the lifetime of LBOs shortening, a recent report by Preqin (Or, 2016) shows that the average time period PE firms hold an LBO investment has decreased from 5.9 years in 2014 to 5.5 years in 2015.

1.2. Context of Research

As companies under LBO are held for a relatively short period of time, which appears to be decreasing, whilst at the same time endeavouring to increase and speed-up their valuation and cash generating capabilities in order to maximise the return on investment (ROI), management needs to be both highly motivated and closely monitored. In some cases, the PE firm will replace some or all of the management team with executives of their choosing; it is however more common for the (majority of the) management team to remain after the LBO, albeit with a major redefinition of the way they operate and of their objectives, in order to be aligned with the interests of the PE firm. In many instances, the acquiring company will require the target's management team to personally invest into the fund capital, thus making sure that they will focus on the maximisation of value and on the completion of the objectives set by the acquirer, as this will also maximise their ROI. Apart from this common approach, there are other governance mechanisms used to align the interest of both parties.

Such mechanisms generally fall under two categories: "carrots", being incentives, and "sticks", being disciplining measures (Peck, 2004). This study focuses on the incentives given to management, namely looking at the various forms and tools for executive compensation, in order to establish if there is an "optimal" mix for particular situations. It will also be taking into consideration particular aspects pertaining to the target company, such as country and tax legislation.

1.3. Contribution to Research

After reading through the available literature, there appears to be a research gap in the area of "executive compensation in firms under LBOs". Although there is vast literature on the subject of executive compensation, namely that by Kevin Murphy, it does not particularly address the packages used in firms under LBOs or evaluate what compensation mixes appear to be most effective. Current papers also seem to have focused on analysing whether incentives or disciplining mechanisms complement or replace each other. However, there seems to be a lack of data on which methods are more effective and on whether or not a model can be developed that predicts the optimal compensation mix for each specific LBO case, based on a series of input parameters.

Therefore, this study aims to address such gap in literature by concentrating on the types of executive packages used in firms under LBO, with a particular focus on France, whilst at the same time comparing and contrasting the observed chosen compensation methods with what can be deducted from the relationships between executive compensation and the actual performance of the LBO'd companies.

This chapter explained the motivation of the study and its relevance to modern trends; the next section's literature review will look at real-life examples, in order to develop research hypothesis and ultimately compare and contrast findings.

2. Literature Review

In order for this study to contribute to a greater understanding of the executive compensation topic, it is important to look at the already existing literature and identify what seem to be the key theories and arguments around this subject, before attempting to draw any conclusions from its findings.

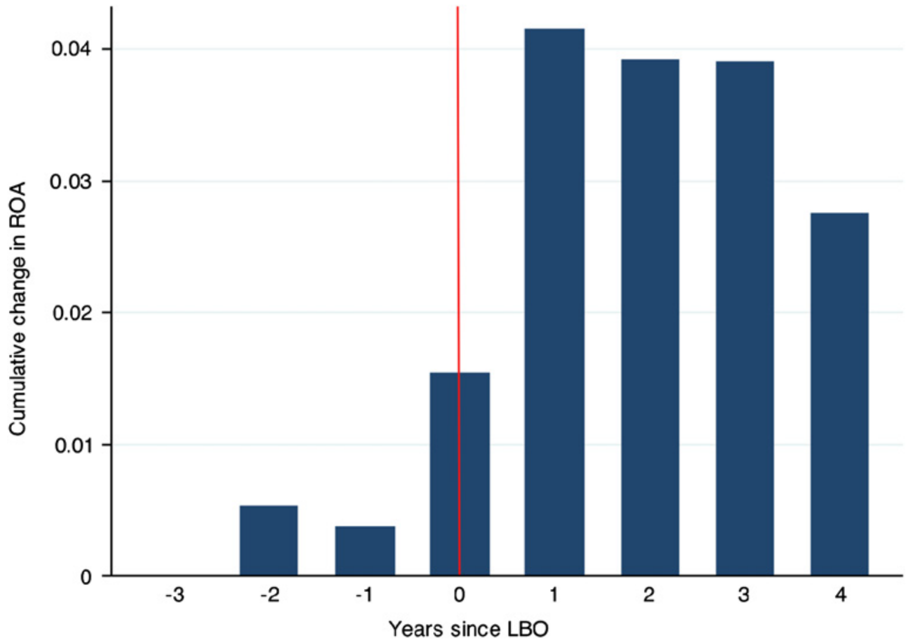
We will now look at LBOs and explain why they were chosen in particular for this study, along with why France was the country focused on. We will briefly cover the most common, currently adopted types of executive compensation and their evolution over the last 20 years. We will then summarise some of the key research hypothesis and findings on the areas of LBOs and executive compensation models, with a final part attempting to compare the theory of executive compensation and their motivational incentives with some real life examples of the actual effects these various compensation mixes had.

2.1. LBOs and Firm growth

Various researches have been conducted on LBOs since their popularisation in the 1980s and most existing studies show that they typically lead to a large increase in the target company's profitability (Figure 2.1). These are statistically significant and robust, as the findings hold regardless of time period and target company size (Kaplan, 1989; Acharya, Hahn and Kehoe 2009). Furthermore, such results are also not dependent on the ownership structure before the buyout.

Additionally, Boucly, Sraer and Thesmar (2011) observed that LBO targets grow significantly more than similar sized and industry firms. Sales (+12%), capital employed (+12%) and employment (+18%), are comparably higher when looking at a period that extends from 4 years before the transaction, to 4 years after. Contrary to the previously mentioned studies (Kaplan, 1989; Acharya, Hahn and Kehoe 2009), these effects appear to be strongly dependent on the target's ownership structure before the buyout as the increase in size, capital expenditure and debt after the LBO is "concentrated among private-to-private transactions" (ibid.).

Figure 2.1 – Mean adjusted increase in profitability around the LBO



(Boucly, Sraer and Thesmar, 2011)

One of the main reasons for these phenomena is the relaxation of credit constraints as the company is acquired by a PE fund (ibid.; Chung, 2009), therefore allowing firms to gain access to growth opportunities that were previously non-exploitable, as the new owners usually bring along financial relationships and expertise, and monitor the firm and management performances better than previous owners, in turn increasing the level of confidence to debt holders; in some instances they bring-in new executives, which may again reassure bankers. Therefore, it can be deducted that LBOs normally result in value-creating transactions that allow target companies to grow at faster rates, as they are typically better managed, made leaner and more efficient, and are granted access to sources of finance that would otherwise not be readily available.

2.2. Why France?

This research has been conducted with the support of *"Messier, Maris & Associés"* (MM&A) a "boutique" Investment Bank with headquarters in Paris and offices in London and New York. Therefore, most of the data obtained through MM&A will focus on companies that underwent LBOs in France.

According to the literature, France is a good country to analyse LBOs as it has a large number of traditional, family-run businesses[3] (Faccio and Lang, 2002), perhaps lacking the managerial and financial expertise they would require to take advantage of all growth opportunities. Such circumstances make France an ideal ground to study potential "private targets with significant margins of improvement and growth" (Boucly, Sraer and Thesmar, 2011).

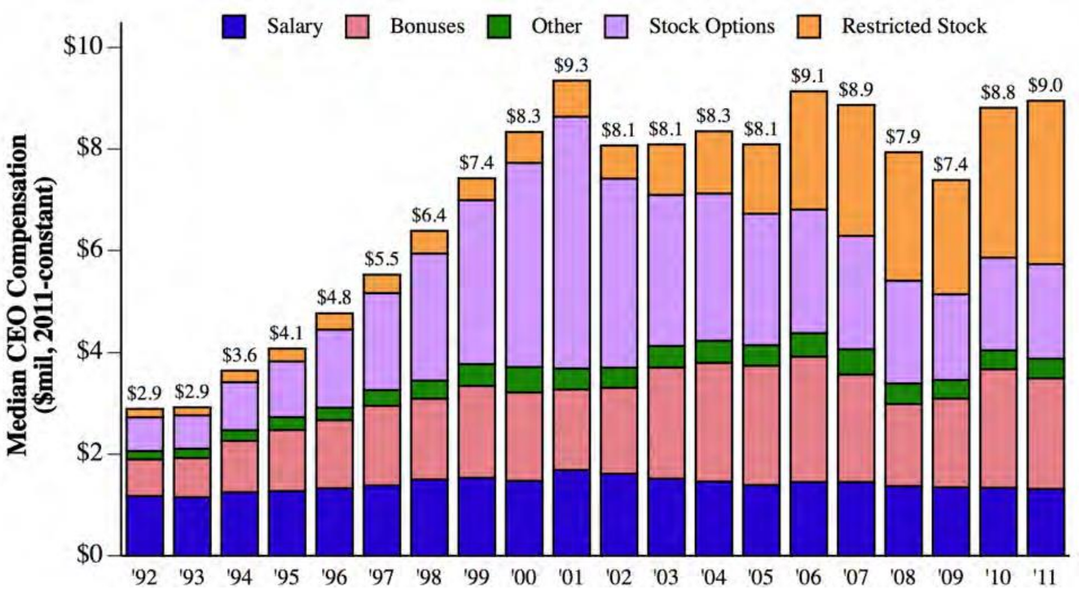
Furthermore, the local stock and credit markets appear to be less developed than those in the UK and US, highlighting the importance of the role PEs could play in helping credit-constrained firms in getting access to external sources of finance (ibid.). Finally, when adjusted to the size of the economy, the amount of LBOs in France is comparable to that of the US and slightly smaller than that of the UK (ibid.), which again is reassuring in terms of availability of case examples and data, and the subsequent relevance of this study.

2.3. Types of Compensation

In order to analyse the executive packages used by firms under LBO, it is important to consider what forms of compensation are, and have been, utilised by business worldwide. Numerous incentive packages have been used throughout the years in order to motivate executives and to try to solve "agency theory" problems. Executive packages typically contain a mix of incentives, which have varied in size and proportion, with some being predominantly used during specific time-periods (e.g. stock options, discussed in Section 2.4). Figure 2.2 illustrates the evolution of these compensations in S&P 500 firms from 1992-2011.

[3] Family run firms tend to have poor governance practices (Bloom and Van Reenen, 2007)

Figure 2.2 – Median Grant-date Compensation for CEOs in S&P 500 Firms



(Murphy, 2013)

From the above graph, we can notice that there has been a 210% increase in total compensation from 1992-2011, with a particularly strong growth in the portion formed by restricted stock. Again, this highlights the importance placed on executive compensation to help drive a company's performance.

The SEC categorises compensation under six types: Base Salaries, Discretionary Bonuses, Non-Equity Incentives, Stock Options, Stock Awards and Others (namely fringe benefits)

Baker, Jensen and Murphy (1988) state that compensation can be broken down into 3 dimensions:

- *Level* – total cost of pay package to employer. Determines quality and quantity of employees an organisation can attract. Firm must offer at least the employee's opportunity cost, or reservation of utility.
- *Functional form* – relationship between pay and performance, together with definition of performance.
- *Composition* – relative weight of the package components (cash compensation, fringe benefits, quality of the working environment, relationships with co-workers, leisure, etc.)

This paper will particularly focus on the later element, "composition", with special focus on "cash compensation".

2.4. Previous Findings

As mentioned, LBOs are of particular interest as they place heavy pressure on management to reach objectives and increase company valuation in a relatively short time-period. For this reason, it is important for the management to be extremely motivated and for their interests to be aligned with those of the acquiring fund.

One of the most common methods used to try to align both parties' interests is to have the management invest into the target company themselves, as part of the "going private" transaction (Peck, 2004). As this is coupled with an increase in leverage, and therefore in default risk, it acts as a powerful incentive to increase operating efficiency. In addition, Peck (2004) also evidences that in LBO's, as compensation forms tied to equity, such as stock options, increase, so does the likelihood of financial distress decrease.

Baker, Jensen and Murphy (1988) discuss how the growth of LBOs is consistent with the theory that slow-growing firms need to find alternative ways to provide incentives to management. They also discuss how, through LBOs and by having management invest in the company, promotion-based systems can be replaced as their ROI is multiplied if they – and their company - perform well.

Peck's (2004) study finds that LBOs are also generally used to "restructure poorly designed incentives rather than to replace poorly performing CEOs" and that the restructuring of these incentives contributes to the success of the LBO (Figure 2.3). This again highlights the importance of well-structured executive packages as one of the determinants of the success of a LBO. However, the paper does not analyse what incentive "mixes" seemed to work best. Instead, it analyses whether "sticks", such as board-imposed discipline or threat of default, complement or substitute "carrots", such as share ownership and compensation. The paper's conclusion is that "sticks" tend to substitute "carrots", rather than complement them. Furthermore, it is likely that incentives such as stock options and internal monitoring by the board are more effective mechanisms to improve management efficiency than externally imposed discipline from debt holders.

Such findings will be compared with the observations of this research, to contrast what is identified in theory to what actually seems to be occurring in the LBO world.

Figure 2.3 – Changes in selected CEO compensation packages around LBOs (medians in parentheses)[a]

	Two years before LBO	One year before LBO	One year after LBO
Change in CEO from previous year	n.a.	9 (15.25%)	10 (16.95%)
Percentage of common stock held[b]	3.77% (0.71%)	2.87% (0.65%)	7.81%** (0.89%)
Implied stock sensitivity per $1,000[c]	37.75% (7.10%)	28.74% (6.51%)	78.12% (8.87%)**
Percentage of common stock options	0.27% (0.02%)	0.18% (0.01%)	3.42%** (0)
Implied option sensitivity per $1,000[c]	1.62% (0.15%)	1.10% (0.06%)	20.55%** (0%)
Number of firms that have a stock appreciation right plan or grant options for securities other than common stock (percentage)	14 (23.73%)	17 (28.81%)	16 (27.12%)
Bonus as a percentage of salary	75.45% (75.33%) (n=12)	73.76% (63.08%) (n=13)	94.58% (53.05%) (n=19)
Total cash compensation/total assets	0.18 (0.05)	0.17 (0.05)	0.20 (0.06) **

* = statistically significant at the 10% level.
** = statistically significant at the 5% level.
*** = statistically significant at the 1% level.
[a]Difference in means and medians of compensation characteristics from the previous is tested. Difference in means tested using a standard t-test. Difference in medians tested using a Wilcoxon sum rank test. Statistical difference in frequencies of number of firms tested using a chi-square test of association.
[b]Stock ownership includes stock beneficially held as an equity partner in the LBO holding company as well as additional stock awarded/purchased during the first full post-LBO fiscal year.
[c]Following Denis (1994), implied sensitivity of options is estimated as 0.6 times the implied sensitivity of the same fraction stake of common stock.

(Peck, 2004)

Some studies have shown that executive compensation contracts exhibit little or no "pay-for-performance" components; Jensen and Murphy's (1988) show that the empirical relationship between top managements' pay and the performance of the company is tiny, even though statistically significant and positive. For every $1,000 change in shareholder wealth, there is only a $0.02 increase in the managements' salary and bonus. However, pay-for-performance theory does not specify the magnitude of the relationship, only that it should be positive, and Armstrong (2013) argues that these notions are largely inaccurate as they result from focusing exclusively on annual pay instead of looking at overall cumulated wealth, which includes stock and options exhibiting substantial performance-related leverage. Additionally, Baker, Jensen and Murphy (1988) believe that pay-for-performance measures are far from ineffective but, on the contrary, can be deemed as too effective as executives are motivated to do exactly as they are told and typically focus only on one measure. It is difficult to specify exactly what management must to do, ergo so is how to measure their performance.

The authors argue that pay-for-performance systems can be measured objectively (quantitatively) or subjectively (qualitatively) and that objective performance measures tend to be less effective than subjective ones, as employees will try to “cheat the system”. For example, piece-rate workers will focus on quantity and are willing to forfeit quality in order to achieve a higher count; this illustrates how employees will be tempted to only focus on one parameter and will forego other important ones, ultimately at the cost of the company.

These findings link to those by Armstrong et al. (2010), who show that contracts designed to satisfy two requirements perform third best and are less efficient than packages designed to satisfy only one of the requirements. Together, these conclusions seem to indicate that executive compensation should be clearly linked to specific, predetermined objectives and management should be tightly controlled in order to prevent them from “cheating the system”.

One example of how managers would behave can be found when looking at a type of compensation that became very popular in the 1990s: stock options. Stock options give holders the right, but not the obligation, to exercise the option of purchasing stock at a predefined price, after a predefined time-period. This basically means that there is a limited downside, but unlimited upside potential for executives holding stock options, as they can be exercised for gain if successful, and let to expire if unsuccessful, with no loss incurred (Armstrong, 2013). Options were granted in the 1990s to so many employees and in such a large numbers, because boards (erroneously) perceived options to be essentially free to grant (Murphy, 2013).

This large issuance of stock options, namely as a form of executive incentive, led to the devise of clever (fraudulent) schemes in order to try to maximise valuation at the time the option was vested. Yermack (1997) observed how option vesting dates for CEOs coincided with favourable share price movements, leading Lie (2005) to investigate this and to expose a “backdating” scheme in which CEOs would exercise their stock call option in an *ex post facto* manner (Jacquart and Armstrong, 2013).

These situations led to government intervention and to regulations being imposed on options, and to companies adopting restricted stock[4] as a form of compensation instead of stock options (previously illustrated in Figure 2.2). Government intervention in executive compensation has been both a response to, and a driver of trends in CEO pay (ibid.). However, attempts to regulate executive pay through tax and disclosure rules have motivated people to try to circumvent these and find loopholes with unforeseen consequences, often leading to scandals and a new round of government intervention (Murphy, 2013).

One of the aims of this paper is to suggest the eventual need for differences in compensation packages, depending on factors such as different regulations in countries or industries.

The reason for the large emphasis on equity related incentives is that executive packages are designed to tackle the "agency problem" and "align the interests of risk-averse self-interested [executives] with those of the shareholders." According to Murphy (2012):

> *the most direct linkage between CEO and shareholder wealth come not from current compensation but from the CEO's existing portfolio of stock, and stock options.*

These findings seem to suggest that a large portion of executive packages should be comprised of stock related compensation, in one form or another; however, the optimal form or mix of incentives is not apparent and we will attempt to identify a value-enhancing approach.

2.5. Theory VS Practice

Contractual theory (Holmstrom, 1979) predicts that pay-for-performance compensation should not depend on factors beyond the management's control, and therefore compensation should be based on company performance relative to industry. This would avoid the increase/decrease in CEO compensation when improved/reduced performance is caused by external, conjectural factors rewarding/penalising "luck" (Jacquart and Armstrong, 2013). One example are the "fabulous" rewards to oil industry executives after huge boosts in company performance due to favourable oil price fluctuations (Bertrand and Mullainathan, 2001) and the recent, opposite phenomena. This theory is nevertheless imprecise, as managers can take actions in order to reduce the company's exposure to external risks through hedging, for example by purchasing derivatives (Baker, Jensen and Murphy, 1988).

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[4] Company stock that is not fully transferable to the receiver unless certain conditions have been met.

However, Boards of Directors do not normally consider relative performance, and Jensen and Murphy (1988) show that absolute firm variations are better at predicting changes in bonuses and salaries than industry relative measures. In addition, due to the existence of incentives such as stock options or shares, which are typically based on a firm's individual performance and not gauged against the industry, again individual performance seems to be a better indicator (Baker, Jensen and Murphy, 1988).

In what is considered a controversial paper, Jacquart and Armstrong (2013) argue that companies should reduce the compensation of top executives, eliminate all of their incentive payments and strengthen corporate governance. The first two propositions seem to contradict the trend adopted by firms worldwide (represented by S&P 500 firms in Figure 2.2). The last proposition seems to be valid, especially after recent scandals on CEO bonuses when companies are performing poorly (e.g. during 2008-2009 bank bailouts) and the previously mentioned stock options "backdating problems". This proposition is addressed by LBOs, since the acquiring firm will closely monitor the performance and behaviour of the target and might even appoint their own executives, whose performances are monitored against specific benchmarks.

There is however evidence on the detrimental effects of reducing compensation for top executives, since this may lead to worse results. Therefore, the authors believe it should be gradually reduced, as many capable employees would be willing to take a top management job at a more modest salary, and indicate several cooperatives and voluntary organisations as examples. However, various literature (Pfeffer and Sutton, 2006 for example) also pointed out that humans, by nature, compare themselves to one another and if they suffer pay disparities against peers, this could lead to a decrease in motivation and job satisfaction. Therefore and again based on literature, the author believes that such an option would only be feasible if all large firms were to simultaneously adopt the same behaviour, a highly improbable and unrealistic assumption.

The argument for the elimination of all incentive payments is found in Jensen and Murphy's study (1990), maintaining that executive compensation should be designed to motivate top management to serve the firm instead of their personal interests; this could be achieved by requiring CEOs to hold a substantial amount of company stocks (which already occurs in many LBO cases), by making the levels and structure of compensation really sensitive to firm performance, and by firing CEOs for poor performance. However, and as no experimental evidence was provided to support these guidelines, the authors propose that incentives should just be eliminated. Again, this study concludes that the elimination of incentive payments is not a viable solution, especially since executives are used to receiving them and will look for alternative positions where incentives are offered, as it is highly unlikely all firms would eliminate them at the same time. Furthermore, it is important to point out that the requirement for management to hold company stock and the structuring of compensation packages to render them sensitive to firm performance has led to a better alignment of interests, as shown in Jensen and Murphy's (1988), Peck (2004) and Murphy (2012).

Hallock and Murphy (1999) collected papers written by other authors into two volumes, which provide other important observations on the comparison between theories and practice. The most relevant findings from these volumes are listed below.

Masson (1971) analysed financial executive incentives and found these to be primarily related to the company's performance on the stock market. The company's sales performance seems to have no consistent effect (be it positive or negative) on the financial return of executives and it was also found that in the post-war period, firms whose management's compensation was more closely aligned with the shareholders' interests seemed to perform better in the stock exchange.

Abowd (1990) concludes that economic and market measures of performance yield evidence that payment of a bonus after a company's positive economic performance leads to increased economic performance of that company in the following year. In particular, a 10% bonus leads to a 0.3-0.9% increase in net profit and a 10% raise in salary after good stock market performance leads to a 4-12% increase in expected total shareholder return.

Sloan (1993) provides evidence to support the hypothesis that earnings-based incentives help to protect investments from the volatility of the stock caused by market wide factors. This happens because earnings are directly related to the firms' change in value (e.g. as a multiple of EBITDA) and therefore the incentives would be less sensitive to market-wide movements in equity value. Therefore, the inclusion of an earnings-based compensation component is suggested, to be used in conjunction with equity-based incentives and in order to mitigate the risk of executives' compensations fluctuating with market factors beyond their control.

Smith and Watts (1992) collected evidence suggesting that cross-sectional differences in the composition of executive packages are related to contradicting theories rather than to tax-based or signalling theories. This is an important element to take into consideration, especially because one of the scopes of this research is to try to identify if factors such as tax legislations impact the choice of executive packages.

The analysis of this and of further literature will serve as a basis to formulate hypothesis and to analyse the case firms in this research. However, although there is quite a vast amount of information on the use and effectiveness of executive compensation, there appears to be a lack of research into executive compensation in firms under LBO. As shown above, LBOs have become increasingly common and are also a means of value creation for the economy and the public, again emphasising the importance of studying them in more depth. Therefore, this research will hopefully address parts of this literature gap and serve as a platform for further studies into this area.

3. Methodology

This chapter will discuss the methodology used during the research and why a "mixed methods" approach was chosen to address both the qualitative and quantitative nature of the research questions and project aims.

Although unique in its approach, this study follows some of the principles and methods discussed in Eisenhardt's paper: *"Building Theories from Case Study Research"* (Eisenhardt, 1989). This study sets-off with no hypothesis to test and no pre-defined theory under consideration. This is important because "preordained theoretical perspectives and propositions may bias and limit the findings." (ibid.) Instead, a semi-structured interview approach is utilised, in order to attempt to answer the research questions formulated with basis on existing literature from the previous chapter and on findings from the quantitative research, and it specifies compensation as an important variable.

The study also loosely bases its approach on that used in Corley and Gioia's (2004) paper, as it similarly addressed management issues and methodological intent.

3.1. Research Questions

This study attempts to contribute to the literature by addressing the apparent gap in research about LBO transactions and how these differ from other – namely public – M&A deals. Therefore and in order to attempt to fill such gap, we will try to answer the following questions:

1. What types of compensation packages are being used in firms under LBOs, namely in France, and do these agree or differ from what is suggested in the literature?
2. Have these changed throughout the years?
3. What seem to be the most important factors in MIPs, in terms of company performance and what management says motivates them?
4. How are particular MIPs affected by external factors (e.g. LBO lifetime, company EBITDA and multiples, tax regimes and others)?
5. Are there notable differences in MIPs between countries? If so, why?
6. Is there a "normal" vesting period for PE and investment funds nowadays and has this changed in recent times? If so, why?

3.2. Sampling

Initially this study set off with the aim of choosing sources that worked in the companies whose quantitative data it would be analysing. Due to the sensitive nature of the data, this was unfortunately not possible.

Sources were therefore chosen based on "purposeful sampling" (Lincoln and Guba, 1985) and with focus on senior management with experience in M&A's, namely in private transactions, as this would best target the proposed research questions.

This study also used Glaser and Strauss's (1967) "theoretical sampling" process, in which "the analyst jointly collects, codes and analyses his data and decides what data to collect next and where to find them in order to develop his theory as it emerges." This was achieved through an iterative process, which commenced by collecting quantitative data and, from this, observing patterns and drawing-up questions to conduct semi-structured interviews. After each individual interview, the data collected was analysed resulting in new questions and themes being generated in order to obtain additional inputs from subsequent sources. This process resulted in the collection of diverse personal "anecdotes" and professional experiences, affording a "real-world" description of these aspects and theory validation, but also permitted the increasingly focused collection of data relevant to the emerging theory.

3.3. Data Collection

3.3.1. Mixed Methods Research

A Mixed Methods of Research approach, increasingly used and recognised over the last decade in the business and social science research areas (ibid.) has been chosen for this study. As the name indicates, it comprises a mixture of qualitative and quantitative research methods and the subsequent use of the findings in one or more of three different approaches, as described by Hammersley (1996). The approaches are: *triangulation*, where one type of research is used to corroborate the other; *facilitation*, which occurs when one research method is utilised to assist research obtained from the other method; and *complementarity*, that arises from employing the two research methods in order to dovetail different aspects of the investigation (Bryman and Bell, 2011). All three approaches will, to a certain extent, be used here.

Triangulation will compare what the quantitative data and literature suggest are the most common and most successful MIPs – in terms of aligning pay and performance – and contrast this to what the management of acquired companies, together with the lawyers in charge of drawing up these MIPs, believe are the “good” and “bad” motivators and performance enhancers, and why this is so.

Facilitation will occur when questions for the qualitative research will be drawn from the findings of the quantitative research, thus allowing for more focus and to “dig deeper” into the findings. This will be conducted through a method described by Bryman and Bell (2011) as “quantitative research facilitates qualitative research” by which, after gathering and analysing the quantitative data, recurring patterns and trends will be observed and then questions will be drawn based on these to obtain a qualitative view.

Ultimately, both methods of research will *complement* each other as they will allow the comparison of what “experts” and managements believe are motivators and performance enhancers and what the data seems to indicate as being the MIP of choice. In order to achieve this, a “filling in the gaps” (ibid.) approach will be incorporated in the research as not all elements of the study can be captured through the quantitative data analysis, and thus qualitative research will be used to buttress the findings.

3.3.2. Quantitative Research

This study will initially attempt a quantitative research approach in order to analyse numerical data on nine French LBO companies, collected through written and electronic documentation. After analysis, emerging recurring patterns of incentive methods will be recorded, serving two purposes: (1) contrasting with existing theory on what executive packages should be composed of, (2) used as *facilitation* to draw-up interview questions in order to get a qualitative understanding as to the effects these MIPs have and why they have been chosen.

This type of research falls under the epistemological orientation of “positivism” as it “advocates the application of the methods of the natural sciences to the study of social reality and beyond” (ibid.). Another purpose of this research is to draw conclusions that are ontologically classified under “objectivism” as the analysis will highlight that the companies have a “reality that is external to the individuals that inhabit it”.

3.3.3. Qualitative Research

The primary research method utilised in this study has been qualitative, due to the nature of the data collected. The qualitative approach lends itself better to analyse the views of managers in companies under LBO, or that have undergone the process of being acquired, as the purpose is to gather person-specific information that will then be used to compare and contrast with what the existing theory, and even the acquiring firm, believe to be the most motivating approaches. This type of research falls under the epistemological orientation of "interpretivism", as it "respects the difference between people" (Bryman and Bell, 2011). In addition, because the conclusions of this analysis will only present a specific version of social reality in the constantly changing subject of executive compensation and motivation, the research will fall under the ontological position of "constructivism" (ibid.).

Data was collected using semi-structured interviews in the form of both one-on-one and phone interviews. This approach matches well the methodology of this study, as there are scheduled questions that cover the issues and topics the research is attempting to answer, but at the same time allows the source to reply to the questions in a way that they find appropriate and gives latitude to enter into in-depth personal experiences (Fisher, 2010). Each interview also attempts to incorporate the "critical incident approach" (ibid.) – if not throughout the interview, then in the form of a final question – in which the sources are asked to recount instances in which a particular MIP proved to be successful/unsuccessful in motivating management and creating value for the shareholders.

The author personally conducted all the interviews, in order to maintain consistency and a clear scope. The sources spoke either for themselves in terms of professional experience with regards to being on the "management side", or they spoke as representatives of their companies when talking about experiences on the "acquisition side".

The interviews lasted 16-100 minutes and were all audio-recorded – after explicitly asking for the sources' consent and letting them know that the recording device could be turned-off at any point, if they so wished – and then transcribed verbatim. Out of the four sources, only one requested the recording-device to be switched-off at the end of the interview, as he recounted a sensitive incident he had been involved in. In this instance, notes were taken during the recount of events and immediately after the interview, again with the consent of the source.

The initial questions (Appendix A.1) attempted to contextualise the source's professional expertise in terms of relevance to this study, as well as addressing questions drawn from findings in the literature and quantitative analysis. They were maintained throughout all the interviews, with additional questions added in order to target emerging themes, as well as trying to identify relationships between these and possible underlying factors. This was done by trying to veer the conversation when specific, reoccurring themes were mentioned, in order to attempt to gain a more in-depth understanding of what these meant to the individuals.

3.4. Data Analysis

As data was collected, it was immediately analysed and compared with that previously gathered and with the literature review findings, following the constant comparison techniques (Glaser and Strauss's, 1967; Corley and Gioia, 2004). It enabled the determination of emerging patterns and themes thus permitting later data collection to focus on these, in addition to the categories and dimension that had already emerged from the quantitative research. It additionally permitted the search for cross-case patterns (Eisenhardt, 1989) through the comparison of ideas and experiences described by the sources.

The qualitative data was analysed by using open coding and by grouping responses into categories, then using axial coding to look for relationships between categories and to identify underlying themes, as well as proposed solutions or ideas on how to address these in a post-acquisition environment. Direct verbatim quotes were also used in order to answer some of the research questions or to explain certain previously observed patterns or phenomena.

3.5. Trustworthiness of the Data

Two steps were taken in order to ensure the trustworthiness of the collected data. First, the sources were chosen based on their historic expertise in the field under research and their status amongst the firms they represented. Second, "peer debriefing" was used (Corley and Gioia, 2004), by which a PhD candidate researcher, within the Business School, was invited to vet the field researcher's ideas in addition to his data collection and analysis procedures, thus gaining "and outsider's perspective." (ibid.)

3.6. Ethical Considerations

This research conforms to The University of Edinburgh's Ethical Guidelines. Due to the project's link to an Investment Bank and the sensitive nature of quantitative executive compensation data, the author of this research foresaw the possibility of confidentiality agreements having to be signed. However and after discussing the issue with the sponsoring entity, MM&A, an understanding was reached that a confidentiality agreement would not be needed, so long as the anonymity of the companies and individuals in the quantitative part of the study is maintained.

In terms of the qualitative data, at the end of each interview the sources were asked whether they wanted their name and the name of the company they represented to be kept anonymous. Only one of the sources requested anonymity, due to the critical nature of some of his information.

4. Findings

This chapter encompasses the results of the conducted study. It will commence by displaying the results of the quantitative research in a table, followed by a discussion on the observed patterns and how these influenced the interview questions, and will then sequentially list the questions posed to senior management and explain the rationale behind these, being succeeded by a short segment on the differences and/or similarities between the source's responses. This results in the identification of patterns and recurring themes that will then be discussed in the following chapter. For each question, tables including the most important themes mentioned by each source, as well as relevant direct verbatim quotes from the transcripts in the Appendix, are included. It is important to note that although there was much information on various topics collected during the interviews, the findings presented will try to focus on the research topic at hand in order to avoid being "overwhelmed by the volume of data" (Eisenhardt, 1989).

Also included is a diagrammatic representation of recurring concepts mentioned in the interviews (including direct verbatim quotes), the linkage between these into overarching themes and, from these, possible solutions to address the particular issues – as suggested by the sources.

4.1. Quantitative Findings

Included below are tables containing the information obtained from MM&A on 9 French LBOs.

Table 4.1 – Information on LBO companies (1)

Company	Country	LBO Round	Sector	Purchase Date	Entry Multiple
Company A	France	2	Internet/Media	Apr-16	9.5x 2015EBITDA
Company B	France	4	Leisure/Acommodation	Dec-15	11x 2015 EBITDA
Company C	France	4	Industrial Products and Services	Mar-15	7x 2014 EBITDA
Company D	France	3	Consumer/Services	Sep-13	9.3x 2012 EBITDA
Company E	France	2	Industrial Products and Services	Jul-13	-
Company F	France	2	Industrial Products and Services	Jul-11	9.0-9.5x 2010 EBITDA
Company G	France	1	Consumer Goods/Wine&Spirits	Jul-11	-
Company H	France	3	Chemicals and materials/Flavours and Fragrances	Jun-07	13x 2006 EBITDA
Company I	France	2	Consumer Goods/Retail	Jan-07	9.6x 2006 EBIT

Table 4.2 – Information on LBO companies (2)

Company	Ratchet Share Mechanism (RSM)	Management investment	Ordinary Shares	Preferred Shares
Company A	Yes (Preferred Shares)	€ 22,000,000	€ 10,700,000	€ 8,100,000
Company B	Yes (Preferred Shares)	€ 19,500,000	€ 15,100,000	€ 4,400,000
Company C	Yes (Preferred Shares)	€ 5,000,000	€ 2,500,000	€ 2,500,000
Company D	Yes (Preferred Shares)	€ 17,000,000	€ 7,600,000	€ 7,600,000
Company E	Yes	-	-	-
Company F	Yes (Warrants)	-	-	-
Company G	Unknown	Unknown	Unknown	Unknown
Company H	Yes	€ 60,000,000	€ 24,000,000	€ 16,000,000
Company I	Yes (Warrants)	-	-	-

Table 4.3 – Information on LBO companies (3)

Company	Warrants Premium	Ratchet Shares	Multiple, IRR, both?	Dividend %	Shareholder Loan	Target Vesting Period
Company A	€ 0	€ 3,200,000	Multiple	9.00%	€ 0	4
Company B	€ 0	€ 0	Multiple	9.00%	€ 0	4
Company C	€ 0	€ 0	IRR	-	€ 0	4
Company D	€ 0	€ 1,000,000	IRR	8.00%	€ 900,000	4
Company E	€ 0	€ 0	BOTH	-	€ 0	-
Company F	-	-	BOTH	-	-	-
Company G	€ 0	€ 0	-	-	€ 0	7
Company H	€ 5,000,000	€ 0	IRR	4.00%	€ 0	7
Company I	€ 0	€ 0	IRR	-	€ 0	5

It can be observed from these tables that most of the companies have gone through at least two LBO rounds and the average target vesting period is 5 years, with the most common target being 4 years. In five of nine cases, there is information that the management has also invested into the company alongside the sponsoring PE fund.

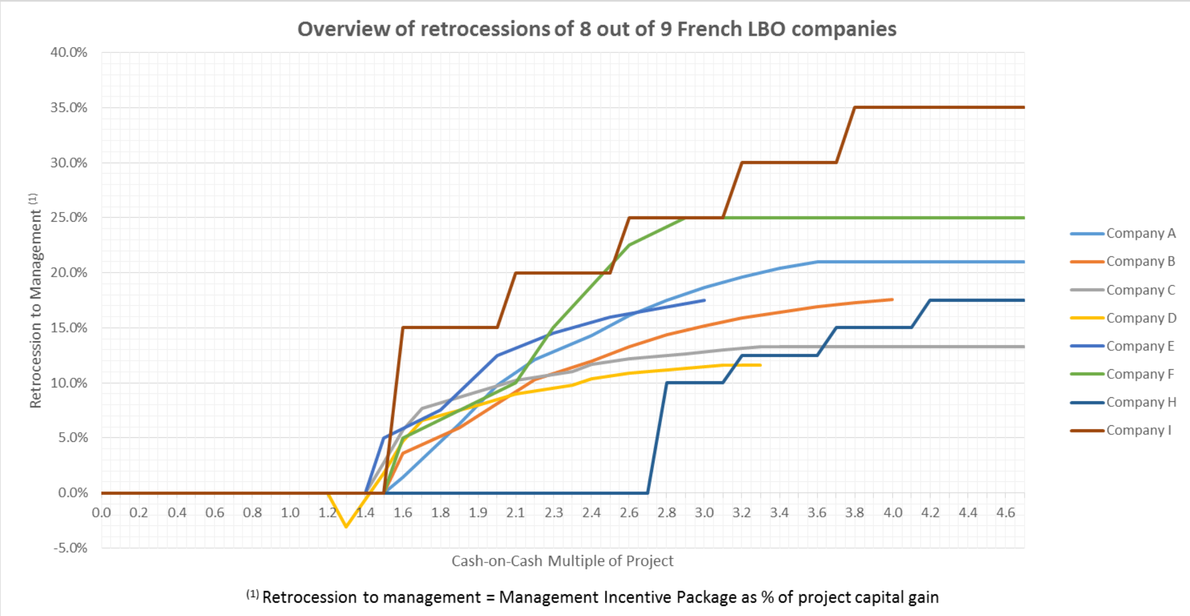
Also to be noted is the extensive use of a "Ratchet Share Mechanism" (RSM), which will be explained and discussed in the following chapter.

Based on these findings, the following questions were drawn-up and subsequently posed to the selected sources, in order to reach an increased understanding on these particular aspects:

1. *In your view, is there a "normal" vesting period and exit method?*
2. *Have you heard of "ratchet share mechanisms" and if so, what can you tell us about them? Are they commonly used in your experience?*
3. *Is it normal for management to also invest in company with the sponsor (i.e. PE/Investment fund)?*

Below is a graphical reproduction of the information contained in Appendix A.3. It illustrates the ratchet structure of the MIPs and their various threshold levels that give access to an increased retrocession on capital gains.

Figure 4.1 – Graph of retrocessions to the management of LBO companies



From the graph it can be observed that most PE funds aim for a CCR of at least 1.4-1.5 before they will grant any management retrocession, with some retrocessions offering the management ample rewards if they excel in terms of performance. This illustrates one way the PE funds try to motivate the management and align pay with performance.

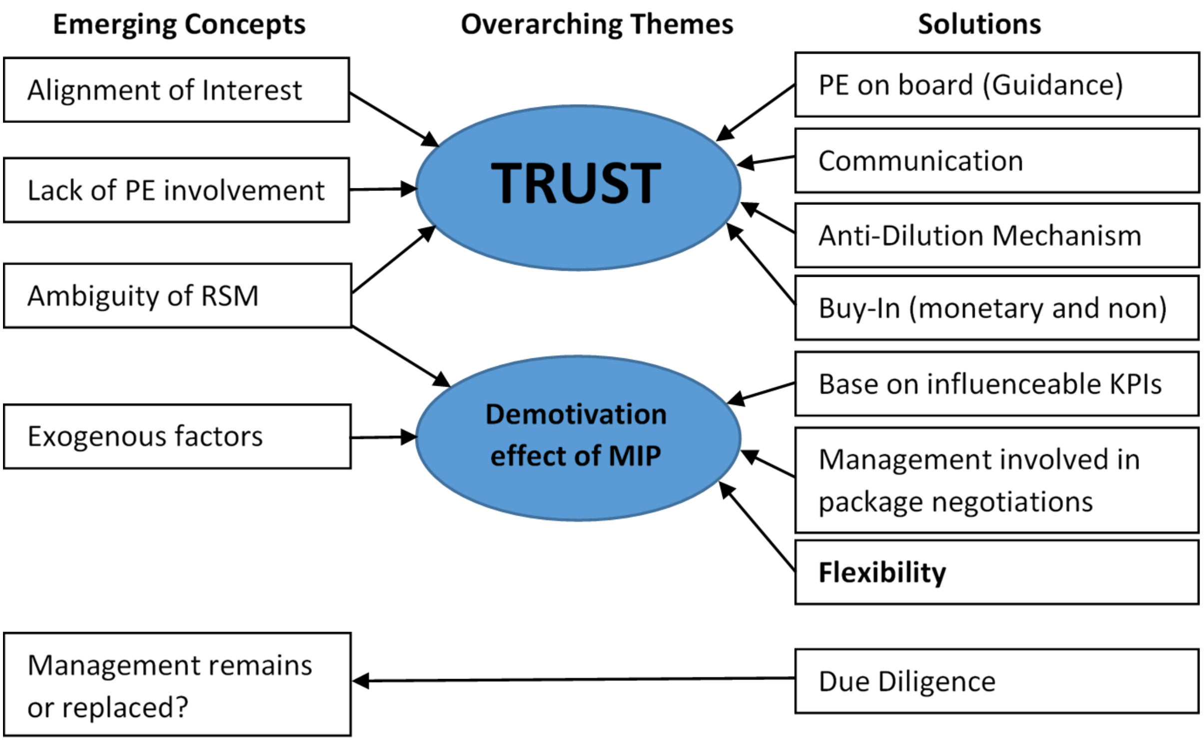
Note also that Company D has a negative retrocession in the eventuality of the CCR being below 1.4.

4.2. Qualitative Findings

The results of the semi-structured interviews are included below in tabular form. These tables are broken down into two parts: (1) answers that directly addressed the questions used as a guideline for the interviews, (2) opinions and comments on recurring themes of particular relevance that emerged during these interviews. The main views from each source are included in these tables, alongside occasional direct verbatim quotes when the author believed the remarks made were of significant importance. From these opinions, overarching points and themes were drawn and summarised beneath the tables.

Some of the themes mentioned are then grouped together into higher overarching themes, and potential solutions to address these themes are then drawn from the discussions with the sources. A diagrammatic representation of these is illustrated in Figure 4.2.

Figure 4.2 – Data structure emerging from interviews



4.2.1. Interview Question Responses

Table 4.4 – Responses to Q1: Experience in LBOs and/or M&As?

Source	Experience / Opinions	Management or Acquirer View
Mr. A	Advising PE funds Worked in management of company run by PE fund CEO of company	Both
Mr. B	CEO & Partner of PE house Vast experience in M&As Experience in implementing PE business plans by working with management	Acquirer
Mr. E	Involved in well over 500 M&A transactions Worked predominantly on behalf of PEs Also first-hand experience from twice selling businesses to PE	Both
Mr. V	Lawyer in charge of negotiating MIPs between PE and management	Both

This question simply attempted to confirm the experience of the sources in the subject of research in order to ascertain the validity of the findings.

Table 4.5 – Responses to Q2: Is there a "normal" vesting period and exit method?

Source	Experience / Opinions	Sector
Mr. A	3 years. Some take longer view Enter and exit is more difficult to execute in a money-creating way nowadays. Availability of funds: "**generally too much money chasing too few good builds**." Financial crisis affected certain PE strategies and vesting periods had to increase Complex mix of drivers Sector and cycle dependant	**Energy/Oil**
Mr. B	It varies Surprised that some PE houses aim for a 3-year period. – "**from my perspective is super-fast!"** JBE's is generally more growth-oriented and therefore their horizon tends to be 5-7 years, due to high CAPEX of sector. Most exits through sale to strategic and financial investors. Not usually IPOs in their sector.	**Food/Agriculture**
Mr. E	It depends very much on the house. **"Typically 3-5 years is the standard sort of cycle, however some have obviously longer holds."**	**Energy/Oil**
Mr. V	"Good leaver" – 4 years "Medium leaver" – 5 years "Bad leaver" – never vest Exit normal through new LBO Trend is increasing vesting period	**MIP Lawyer**

The question aimed to address the article by Or (2016) and see if indeed the duration of LBOs is decreasing. Different PE houses have different target durations, with JBE for example having a longer period due to their higher CAPEX, but it appears that most aim for 3-5 years and that this is increasing.

Table 4.6 – Responses to Q3: Have you heard of "ratchet share mechanisms" and if so, what can you tell us about them? Are they commonly used in your experience?

Source	Experience / Opinions	Used	Familiarity with concept
Mr. A	**"I understand how it works, but I haven't personally been involved with it."**	No	Yes
Mr. B	Have something similar but not specifically a RSM. Works on the basis of "carry[5]" rather than through the usage of financial instruments, as JBE tend to work with non-listed companies.	No	No
Mr. E	Standard incentive	Yes	Yes
Mr. V	Designs ratchets Decreasing usage in France since appointment of new government and its fiscal policies, but very common in UK	Yes	Yes

The findings seem to indicate that the RSM is a widely used mechanism both in the UK and in France, with the usage in the latter having decreased recently. From the interviews, a sense of ambiguity as to how this mechanism works was sensed, and this will be included in the discussion later in this study.

[5]Also known as "Carried Interest". A percentage of the investment profits which is paid-out to the investment manager (in this case the PE).

Table 4.7 – Responses to Q4: Is it normal for management to also invest in company with the sponsor (i.e. PE/Investment fund)?

Source	Experience / Opinions
Mr. A	Common practice, but unsure of whether or not it's a good practice. In one deal they didn't have to invest in company, in another they did. **"My attitude to the success of either of these was no different. It is the challenge that is driving me, not the cash"** Had higher salary when they didn't have to invest and upside of second deal was only marginally better.
Mr. B	When they are hired as consultants, they are rewarded by the company. **"In return for that, we get an equity stake sometimes, as well as a cash component."** Need for management buy-in, be this financially or purely motivationally. This is achieved by working closely with management and involving them in processes like design of the business plan and budget. – **"It's all about accountability as well."** Management tend to be shareholders as well, which renders interest alignment easier.
Mr. E	**"In most cases the Private Equity will not invest unless there is management alongside it. So therefore, it is usually a precondition of a Private Equity deal that the management is aligned. If the management doesn't want to be aligned or is not interested in being aligned, then 9 times out of 10 the Private Equity will not do the deal."**
Mr. V	Quite normal in France, but not necessarily always the case in the UK. Description of various mechanisms used (to follow in Discussion Chapter)

Management investment into the company seems to be common practice, as it ensures interest alignment. Some sources consider this buy-in as critical for the success of the venture, whilst others claim that it is the mission and a close bond between management and PE that are the main success drivers.

Table 4.8 – Responses to Q5: In your experience is management more closely monitored after an acquisition? If so, how? Milestones set? Reward or Punishment ("Carrot" or "Stick") and why?

Source	Experience / Opinions
Mr. A	Basically, only "Stick" is firing people. Otherwise just an "agree to disagree" by exit.
Mr. B	Business plan constructed with management **"with annual or semi-annual milestones in terms of: increase in sales, increase in production and as well increase in growth margins. So very much a growth story."** Budget is a very important tool – **"not just a theoretical exercise" –** to monitor performance and used to set "carrots". Hence one of the reasons JBE likes to sit on the board of these companies. "Stick" is either not getting a bonus or getting fired in extreme situations, but "not-aligned" management would normally be replaced at beginning of project. Personally does not believe "stick" works very well.
Mr. E	"Carrots" rather than "Stick" PE might hold 1 or 2 seats on board for financial monitoring purposes and provide guidance. If company is constantly underperforming, then CEO might get fired
Mr. V	"Stick" is firing managers. Management-set milestones to achieve and unlock RSM rewards

It seems that PE firms like to have representatives sitting on the boards of the acquired companies to monitor and liaise with the management. Firing of a manager seems to be the main "stick" used, but only *in extremis.* "Carrots" are put in place to motivate management and underperformance means they cannot be "harvested".

Table 4.9 – Responses to Q6: Do you have any experience in looking at, or adjusting management compensation or MIPs? If so, can you tell us about it?

Source	Experience / Opinions
Mr. A	Overseen numerous different examples, both in public and private companies and private equity. Difference between countries as some don't care for financial instruments or some hold a lot of power and strike hard bargains. Have to respect their culture Hard to align public and private companies' pay after acquisition.
Mr. B	Part of the Due Diligence process. If they believe adjustment is needed to align interests, then they will do so. Again easier if management is also shareholder.
Mr. E	"Yes, certainly I do. The majority of compensation packages don't necessarily change very much from a "monthly dollar take-home" perspective…" PE house will **"incentivise management on exit. On valuation exit, not on valuation going forward. They may say that if you beat budget and get to a higher valuation throughout the journey of the investment, that there will be additional bonuses set up accordingly."**
Mr. V	**"Cannot play on every field" –** either high base package or bonus. Can't have it both ways. Not all managements like same MIP Usually there's a 5-10% increase in wage and bonus scheme

Findings highlight how there can be no "universal" MIP mix due to differences in management preferences and motivations. They also highlight that in LBOs there is either a high salary or high performance bonus on exit, and that normally the existing salary is not changed too much.

Table 4.10 – Responses to Q7: Any particular cases of successes/failures related to company performance and MIPs?

Source	Experience / Opinions	Type and main cause
Mr. A	Failure due to deceptive valuation by PE fund. Let to breakdown of trust and also was demotivating Management eventually left and could have sued	Failure -> Deception by PE fund
Mr. E	**"Ratchet mechanisms do not work well right now in the oil and gas sector. Where, not due to fault of management, the oil prices dropped and therefore the company just cannot hit its forecast targets."**	Failure -> RSM not working as unachievable thresholds due to exogenous market factors. PE refusing to reset benchmarks
Mr. V	For MIP to be effective you need someone to buy in further rounds. e.g. ELIS Brake case where management invested £1,000-2,000 and got return of £200,000 Converteam case where management made 5,000 times ROI. Vivarte almost went bankrupt due to extremely high leverage even though MIP was extremely good.	Success/Failure depending on point of view. Huge management bonuses can cause public controversy and lead to tighter institutional regulation. Timing of exit is critical as time-factor can destroy a MIP due to compounding interests. Need to take into consideration the 3 factors for a successful LBO: EBITDA, multiple, leverage.

Quite a few failure cases reported, due to various factors, both internal and external; to be further analysed in the next chapter.

4.2.2. Emerging Themes

Table 4.11 – Responses regarding: Alignment of Interests

Source	Experience / Opinions
Mr. A	"Alignment may be completely different to your alignment" "It's not so much that people are doing everything because of the money. It's just that therefore when one doesn't change to align with the activities, then it doesn't become credible" "If you're going to… an acquisition. I think you have to be really clear on the softer issues as much as the harder issues." Important to discuss exit with management (both exiting and remaining)
Mr. B	Alignment of interests is key! Try to achieve this by having managers as shareholders, by having management input in budget building and business plan, and by sitting on the board to set target milestones and incentives based on achieving these. Try to align interests by sharing part of their profits with the management they hire – "part of that will be "kicked back" to the person who is doing that on behalf of us." Alignment by management "buy-in" – "could be in the form of an additional cash contribution as well, but most importantly it's that in their mind-set they support what we think we can do. Because otherwise, it's never going to work."
Mr. E	Management should invest alongside PE in order to align interests
Mr. V	Alignment of interests is our "mantra"

Alignment of management interests with those of the PE is vital and was already previously discussed. One way of ensuring these are established is again by having PE members sitting on the company board and design budgets and business plans with management input. Another way is to have management share in the profits of the PE (e.g. ratchet structure), possibly by also becoming shareholders

Table 4.12 – Responses regarding: Trust

Source	Experience / Opinions
Mr. A	Mentions “trust” 8 times. Trust breaks down if “fairness” element seems to be lacking **“trust and transparency to any incentivisation scheme is critical."** – personally involved in incident where there was no transparency and this led to **“breakdown in trust”** So it’s around **transparency** and **trust**. Which again is **not to the heart of money incentive schemes.** Learning from past experience, they would only sign deal where they knew their percentage was fixed, **“and again that comes back to trust and transparency and the level that you feel you are in control.”**
Mr. B	In their model they employ people and form relationships, and they don’t try to extract cash at every opportunity, but rather try to create value through growth and then get rewarded based on that. **“Trusting and it’s a lot to do with engagement”** **“Important as well is that you be very transparent, up-front. In the sense that when you set those targets, you clearly explain to management what is expected of them and how they are rewarded.”**
Mr. E	Trust and transparency vital from both parties when establishing budget and incentives based on it; e.g. no “sandbagging” the budget “Have to have is an **open, honest relationship with the management team”**
Mr. V	PE should use Fair-Value valuation

Trust and transparency are also vital elements, which are not inherently at the heart of incentive schemes. Management involvement, transparency from the PE, fair treatment of management and honouring contractual agreements, all help establish trust between the parties.

Table 4.13 – Responses regarding: Industry Relative compensation mechanisms

Source	Experience / Opinions
Mr. B	**"Performance of your peers is taken into account as well…"** normally in the form of budgeting. It is a subconscious process… not deliberately thinking of particular peers, but rather of what market trends are. "**Hard thing is to find the appropriate peers"** Some "peers" might not have anything to do with you.
Mr. E	Thinks that it's **"aspirational rather than actually fact.**"

This links to the propositions by Holmstrom (1979), that compensation should be based on company performance relative to industry. However, the author believes that this is very hard to implement and agrees with Mr. Evett's statement.

Table 4.14 – Responses regarding: Demotivation of MIP - Flexibility Required

Source	Experience / Opinions
Mr. A	"**I have seen where the nature of the challenge changes… But the incentivisation scheme doesn't.**" **"It's not so much that people are doing everything because of the money. It's just that therefore when one doesn't change to align with the activities, then it doesn't become credible"**
Mr. B	When drawing up MIPs, there should be room for interpretation and differences in case unexpected events occur. e.g. financial or market crisis **"If you would define your performance metrics as well, you would say: "you get a certain bonus if you perform 5%, 10% above budget." So that budget, you know what the general growth plan is, but you at least allow for a flexibility to adjust the budget, and budget is mostly set on a yearly basis by management – so they have an influence there – and then is approved by the board. Which again is us."**
Mr. E	Story of how due to oil price drop, some targets have become unattainable and thus "**that sort of ratchet is actually a significant disincentive to management."** **"So effectively what you have to do, or what equity has to do in this scenario, is reset management requirements."** **"Can't use the same incentive package. Otherwise it's totally disincentivising management."**
Mr. V	Can be frustrating if multiples and therefore price on exit decreases even though performance has increased. Can lead to demotivation and managers to leave since they do not want to lose any more value.

It appears that MIP can, in extreme situations, have a disincentive effect on management if not adjusted and therefore flexibility may be required. Flexibility can be attained by putting in place performance metrics against budget, which is partially controlled by management. A good equity house should monitor MIPs and be willing to reset these if they appear to be unattainable (e.g. due to exogenous circumstances), in order to prevent a disincentive effect.

Table 4.15 – Responses regarding: Country Differences

Source	Experience / Opinions
Mr. A	US culture is more money oriented than Europe. Story of how in Chile JV money was not the solution and how they had to be flexible and construct individual management incentive deals. Story of how in Indonesia they had to follow the traditional compensation methods and not their PE methods. - **"you shouldn't impose that on a culture who doesn't understand it or want it."** Ukraine story on how GM raised staff salary to make them happy.
Mr. V	France uses different mechanisms than UK/US/Germany as stricter tax regulations. France most "aggressive" country for management. Usually requires management to invest whilst UK&US require minimal or no investment. Ratchet mechanism doesn't work in Germany. Have to implement sweet equity mechanism. Luxembourg very flexible on financial instruments – **"in a sense you can do whatever you want in Luxembourg."** Normally differentiate UK and continental Europe when looking at vesting periods.

As was expected, there appear to be significant differences in the mechanisms used in different countries. The reasons for why this occurs will be explored in the following chapter.

Table 4.16 – Responses regarding: Exogenous Factors

Source	Experience / Opinions
Mr. A	2008 crisis affecting company's performance and also PE funds strategies. Some PE funds having to change strategies and this is causing longer vesting periods.
Mr. B	If exogenous event like a crisis occurs, then you can deviate from initial budget appraisal Multiple is dependent on market sentiment -> management cannot control this Performance measures should all be able to be influence by management and should be readjusted if events beyond the management's control occur.
Mr. E	Oil prices have dropped and this has made ratchet based MIPs unattainable and led to a disincentive factor to management.
Mr. V	Multiple and Leverage which are 2 of 3 factors for successful LBO cannot be controlled by management. Frustrating when company is performing well but multiple on the market has decreased and there is nothing management can do to change this. Vivarte almost went bankrupt due to over-leverage and 2008 crisis. (Miecamp, 2014; Ruckin, 2014)

There appear to be several exogenous factors that can affect the MIP and which management has limited control over. MIPs that could be heavily influence by these factors should be avoided and *in extremis* reset in order to ensure the management is not demotivated. Again, how this can be achieved will be discussed in the next chapter.

Table 4.17 – Responses regarding: Effectiveness of MIP

Source	Experience / Opinions
Mr. A	Pay is not everything - **"I think that the package itself can be important, but I think the environment of the owner, is more important".** Gives example of how Charterhouse has a good reputation of working with management teams. – "**that would weigh much more for me than another 1 million pounds at the exit"** MIP only effective if management is followed by PE house Mentions again transparency and trust as key factors to MIP effectiveness Anti-dilution measures are a "must"!
Mr. B	Managers they put in had their package based on meeting milestones set by them. **"In order to attract people you need to give them a fair base package."** More effective alignment of interests if PE fund become majority shareholder and are transparent with management. They engage management in the development of growth strategies and set **realistic** incentives – based on business plan and performance metrics that management can influence. **"People tend to work more because they want to make it to success, you know? There is other ways to incentivise and other ways that drives people than just the package. Fortunately."**
Mr. E	Incentives should be set one exit. Good example seen of a ratchet were if management beat budget – thus creating value for company – 25% of incremental revenue was split amongst them. Good equity house will guarantee MIPs effectiveness by making sure that "**if management start to get stopped from doing everything to do that"** they **"actually try to modify its incentive package so that the management team can still attain those sort of numbers that they actually invested on."**
Mr. V	Packages extremely good at retaining people, not necessarily loyalty. Example of GM that uses a lot of "stick" but management persevere as they have very good packages and want to get big upside on exit. Have to limit package to 15-20 managers in order to ensure effectiveness, otherwise value gets too diluted. Anti-Dilution – "The Holy Trinity" Not effective with every type of management (e.g. restaurant managers want to cash in money and don't want to be "stuck" with one company)

It is clear that pay is not the only determinant of performance and that it is fundamental for the management and the PE house to have a transparent and trustworthy relationship. Dilution protection is a must when undertaking such kind of deals; the "Holy Trinity" that ensures this will be discussed later. The MIP will only be effective if management is able to influence performance variation; if not so, then PE might need to intervene and adjust MIP.

Table 4.18 – Responses regarding: LBO vs Public Companies

Source	Experience / Opinions
Mr. A	Problems with integrating cultures after merger of public and private company
Mr. V	Completely different remuneration scheme as in PE there's an investor injecting money and in strategic acquisition there isn't as usually on a "share-for-share" exchange basis Strategic acquisition normally doesn't have an incentive package put in place – clients are **"very afraid and fear strategics because they know that they are going to lose everything. Because no package will be implemented."** Implementing an MIP in a public company is completely different. In public company you are **"not in a position to easily compute a return… Because you have many shareholders who have invested on the basis of various prices, because you are stepping into the company at X or Y price depending on the listing – on the price – you never know."** In public tend to set LTIPs, based on preferred shares, pre-shares, stock options that will be triggered at an achievement of certain performance milestones, to replicate bonus, but does not entitle management to a portion of shareholder capital gains. Return of public MIPs is much lower than that of LBOs

The main focus of this study is to analyse MIP in LBOs and how and why these differ for other M&A transactions and from public companies'. Some of the differences are illustrated above and will be a topic of greater focus in the discussion chapter.

Table 4.19 – Responses regarding: New Management or Existing one?

Source	Experience / Opinions
Mr. B	Tend to leave existing management, unless they think management is underqualified or lacks experience to execute aspects of new business plan. – **"if it's commercial development, we would bring in someone who we think can execute that commercial development."** Due Diligence important to determine competence of management
Mr. E	Both depending on skills of existing management, which are determined during Due Diligence. "Gap analysis[6]" used to determine if additional staff is required. **"Often you are looking for somebody with a bit of experience, an alignment and an understanding of the business, so that you are not sort of educating management for 6 months before they actually make a contribution."**
Mr. V	Incumbent management usually stays in place. **"If they are not the best managers of the surviving entity, they will be fired."** If during negotiations there's a feeling that the PE might try to replace management, then a "golden parachute[7]" is negotiated to protect management for at least initial 2 years **"When you've been through many rounds of LBOs, well your size has been increasing as well. You might end up with a big company with the same management as the one that made the first round. And you might have sometimes discrepancies, where the CFO just doesn't know how to manage… I don't know, bonds, complicated financing structure, all this kind of debt and so on. You might find someone who… I don't know… Well, for example someone who doesn't speak English for instance. In France this might happen."**

It appears that as much as possible, the PE funds try to maintain and work with incumbent management unless there are vast incompatibilities or management inexperience to execute the business plan. This seems to be determined pre-acquisition, in the Due Diligence stage, as to avoid any surprises.

Although there are several concepts and interesting topics emerging from the findings, the next chapter will focus on discussing those that are most pertinent to the research focus.

[6] "Gap analysis seeks to define the current state of a company or organization and the target state of the same company or organization. By defining and analysing these gaps, a business management team can create an action plan to move the organization forward and fill the gaps in performance." (Investopedia, 2010)
[7] A "golden parachute" is essentially a clause that awards the management with a large payment in the eventuality of their dismissal.

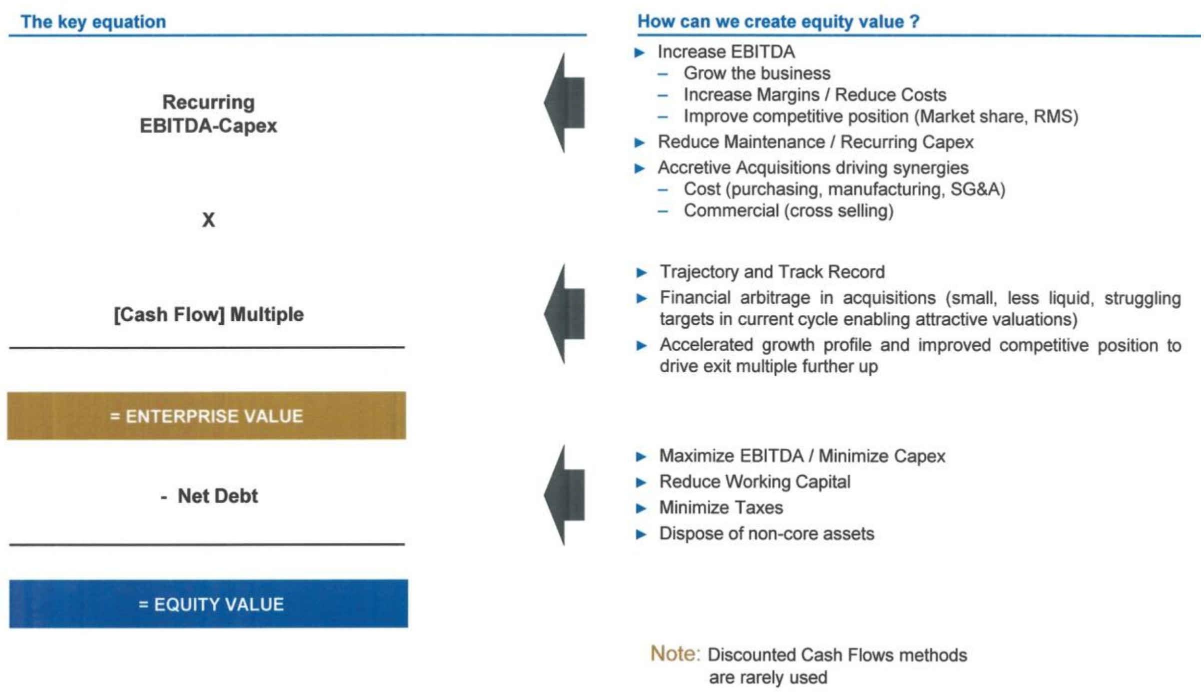
5. Discussion

This chapter will compare and contrast the findings of the conducted research with the literature review and attempt to provide answers to the research questions.

Sub-headings are used to address what the author believes to be the main issues surrounding MIPs that have emerged from the interview discussions and the quantitative research.

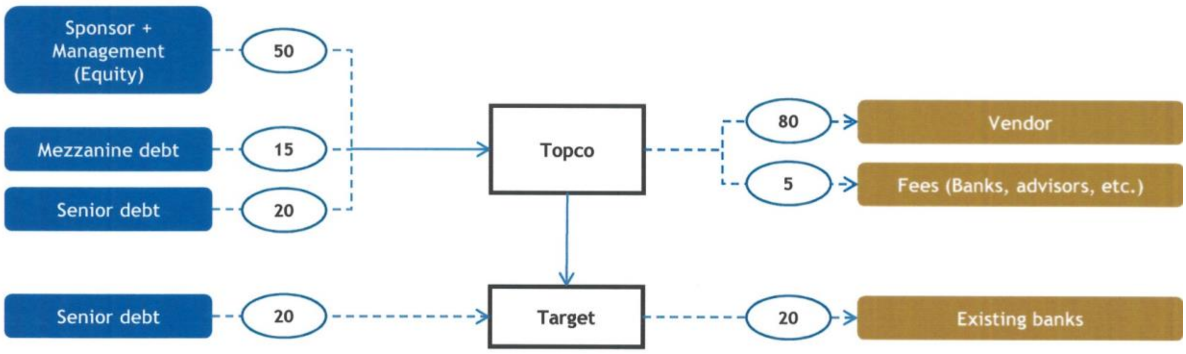
Also illustrated before the discussions are diagrammatic representations of the fundamentals of LBOs and PE operations (Figure 5.1 and Figure 5.2)

Figure 5.1 – Fundamental M&A equation and ways in which value can be created



(Confidential Source, 2011)

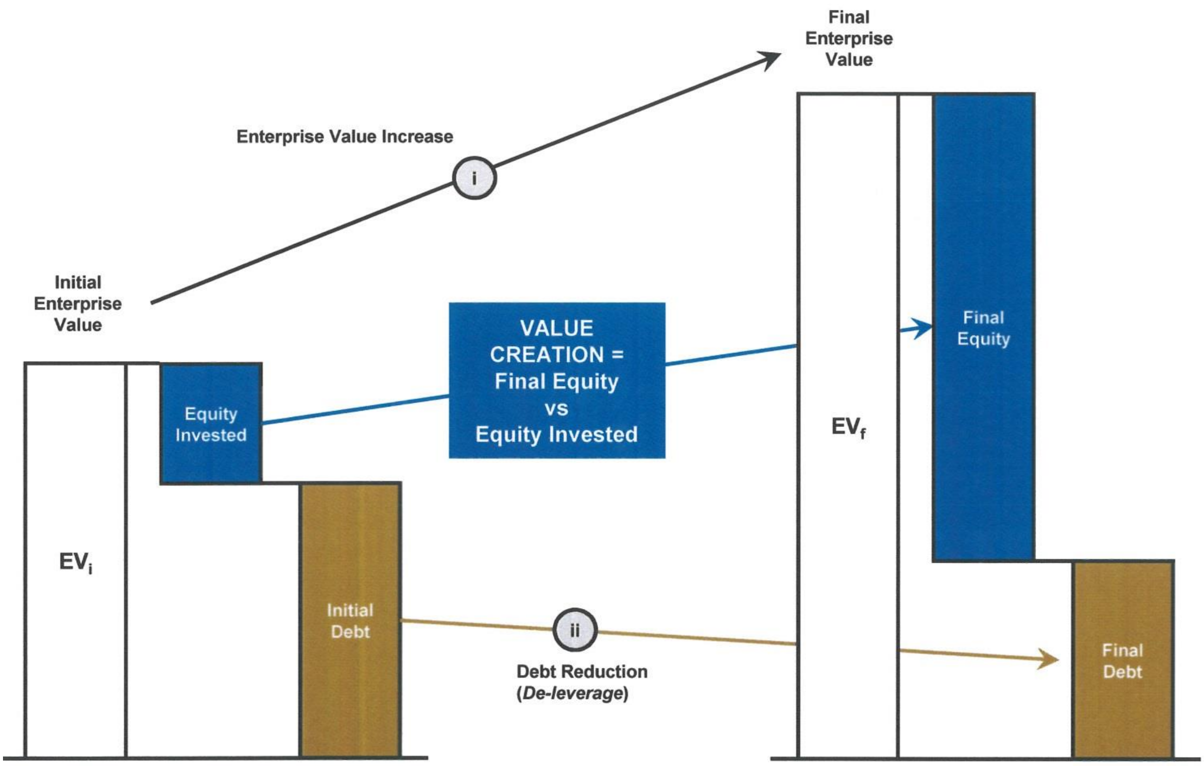
Figure 5.2 – Example of typical LBO acquisition structure



Sources			Uses
Equity	50	Pay shares to vendor	80
Mezzanine	15	Refinance existing debt	20
Senior debt	40 (20+20)	Pay fees	5
Total Sources	**105**	**Total Uses**	**105**

(Confidential Source, 2011)

Figure 5.3 – LBO Value creation principles: (1) EV increase and (2) Net Debt reduction



(Confidential Source, 2011)

5.1. Tax Efficiency

The research seems to indicate that a fundamental aspect when designing MIPs, – and one that this paper particularly aimed to determine the impact of – is taxation. One of the main concerns with MIPs is to create a "tax-efficient structure"; "it's always a tricky issue tax and especially in France" (Appendix A.7, p.112) and, since the changes that followed the appointment of French President François Hollande in 2012, the structures and mechanisms of MIPs have had to change in order to adapt to increased taxation. The revised packages try to avoid falling under "taxation on remuneration" and are designed to have the "earnouts" fall under the capital gains category, as this is taxed at around half the rate (French-property.com, 2016a,b,c).

Also of note is that differences in tax regimes between countries affect the choice of which MIP mechanisms are put into place, as will be discussed in the "Cross-Country Differences" section, further below.

These findings address the study's aim to establish if factors such as different tax legislations affect the choice of executive packages and seem to suggest that not only this is the case, but also that it is one of the key elements to be taken into consideration during the package construction stage. The findings agree with Murphy (2013), since PEs are circumventing attempts to regulate executive compensation through tax legislations, but disagree with Smith and Watts (1992) who suggest that differences in the composition of executive packages are not tax related.

5.2. Mechanisms Used

The interviews yielded findings as to compensation mechanisms used in LBOs in France – with their strengths and weaknesses, how these have changed during the years and why, how these differ from those used in other countries and why, and other aspects that affect the motivational effectiveness of these structures.

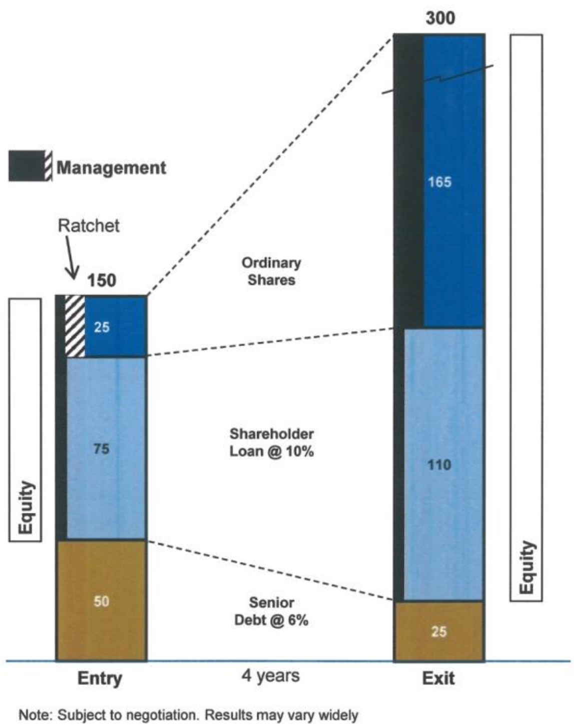
5.2.1. Ratchet Share Mechanism (RSM)

One of the tools used in France and elsewhere are "ratchet tools", so-called Ratchet Share Mechanisms (RSM). This method relies on instruments such as share options, warrants, preferred shares, etc., which entitle the management to a portion of the capital gains on exit "that has nothing to do with [the management's] initial investment" (Appendix A.7, p.112). The PE fund normally has a target minimum ROI (CCR) or IRR, above which there are different thresholds that – if attained by management – will unlock the allocation of different percentages of the capital gains[8] as a "premium"; this is the same concept explained in Section 4.1 and illustrated in Figure 4.1. A "ratchet is just a "relution" [accretion], you just get an increased share of capital gains, based on performance milestones, which has nothing to do with your initial investment" (ibid.). There is a clear relationship between pay and performance, as the management gets increasingly higher rewards, in the forms of bonuses, as the performance of the company increases, thus attempting to motivate the management to achieve these high goals.

This can however result in disproportionate management compensation, as was the case of Converteam (Arnold, 2008), where the company's eight top managers received a €700 million pay-out (ibid.) after having "invested something like 1 million euros" (Appendix A.7, p.113). It also means there is limited downside to the management if the performance is not good, as their loss is limited to the amount they initially invested into ordinary shares.

An illustration of how disproportionate the bonus management can receive with RSM is shown in Figure 5.4, with Figure 5.5 showing how the mechanism also protects the downside to management.

Figure 5.4 – Illustration of potential RSM upside



Equity Value - Entry

	Mgt	PE	Total
Ratchet securities	0,300	0	0,3
Ordinary shares	0,421 (1.7%)	24.279 (98.3%)	24,7
Shareholder loan	1.279	73.721	75,0
Total	2,000	98,000	100,0

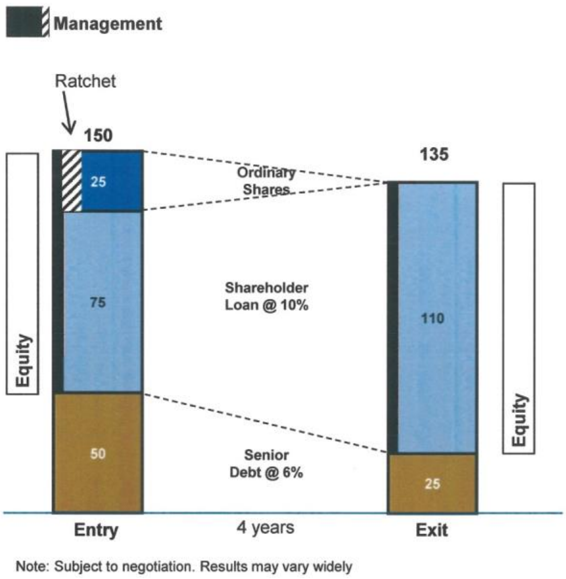
Equity Value - Exit

	Mgt	PE	Total	
Ordinary shares	16.50 (10%)	148.5 (90%)	165	X6.6
Shareholder loan	1.87	107.9	110	X1.47
Total	18.37	256.4	275	X2.8
	X 9.2	X2.6		

[8] Capital Gains of the project are the proceeds to the sponsor/investor, net of initial investment. This may take into account the management's initial investment if they were required to buy-in alongside the sponsor.

(Confidential Source, 2011)

Figure 5.5 – Illustration of management downside protection with RSM



Equity Value - Entry

	Mgt	PE	Total
Ratchet securities	0,300	0	0,3
Ordinary shares	0,421 (1.7%)	24.279 (98.3%)	24,7
Shareholder loan	1.279	73.721	75,0
Total	2,000	98,000	100,0

Equity Value - Exit

	Mgt	PE	Total	
Ordinary shares	0	0	0	X0.0
Shareholder loan	1.87	107.9	110	X1.47
Total	1.87	107.9	110	X1.1
	X 0.9	X1.1		

(Confidential Source, 2011)

This mechanism is capped in terms of the percentage of gains the management can get, as shown in Figure 4.1; there is however no cap on the valuation of the company, and thus no limit on the value that the financial instruments can reach. Because of the huge upside potential, these mechanisms can – and have, like in the case of Converteam – cause public uproar, constantly fall under the magnifying glass of the tax authorities and are "heavily, heavily challenged". The main weakness of this mechanism is – as French tax authorities put it – the valuation of the financial instruments upon investment, whereby they consider that the PE houses have intentionally undervalued them in order to reach a higher upside; the PE houses argue that they are not undervalued, due to the risk-factor involved in these transactions. Regardless, it is important to note that any valuation must to be verified by an independent, third party auditor.

From the data collected in the interviews, there appears to be a certain ambiguity about how RSM works, which suggests that the management is often not sure of the mechanism and of what it entitles them to receive. Even though lawyers have "the obligation to explain these concepts to managers before they agree to these terms", in his opinion there are "not so many lawyers who understand both finance and legal issues."

> *I'm not sure that you have a presentation made by independent lawyers in every transaction. Well, when I say I'm not sure, I'm pretty sure it's not the case. And we have, for instance, we have colleagues at other firms who have been just sued by their client managers, because of lack of explaining and then the managers were claiming they weren't fully informed and so and so… And they were challenging their investment decision.*
>
> *So… In the underline, no I don't think that every manager is fully aware of what they are doing.*
>
> (Appendix A.7, p.119)

Another issue is the fact that PE funds sometimes try to "cheat" management by reducing their percentage of proceeds after capital injections, enticing management with a bigger remuneration in terms of absolute values, but lower in terms of the percentage they are contractually entitled to. One of the sources told (microphone off) how a PE fund had overvalued the business initially and therefore the management could not achieve a better valuation for the duration of the project, no matter how hard they worked.

Due to the heavy taxation, disputes, and pubic uproar stories on RSM, MIPs in France have nowadays shifted to alternative structures, namely to the so-called "Sweet Equity" mechanisms.

5.2.2. Sweet Equity

At the moment this study is made, Sweet Equity appears to be the "best instrument to structure a management package in France" and is used in around 85% of all LBO deals in France.

The way it works is that, unlike RSM, the management upside is not triggered on the basis of performance milestones. Rather, the management and PE will both invest in ordinary shares and in fixed-rate instruments (FRI) such as bonds, convertible-bonds, preferred shares etc. They will do so in different percentage levels, with the management ideally investing 70%-80% of their equity into ordinary shares – rendering them specially sensitive to firm performance which, as shown by Jensen and Murphy's (1988), Peck (2004) and Murphy (2012), leads to better alignment of interests – and the remaining 30%-20% into FRI with an interest rate of 11%-12%. The PE fund will do the opposite and invest around 20%-30% in Ordinary Shares and 80%-70% in the same FRI.

By doing so, both parties are ensured – but in the event of total collapse – that at least the portion of their capital invested into FRI will yield a return as compounded interest is accumulated. In addition, if the management perform well and the company's EBITDA grows significantly, with the resulting EV increase – assuming the valuation multiple remains constant – then on exit, the management will be entitled to a larger portion of the capital gains as the EqV increases; the PE fund will necessarily also benefit from, but in a smaller percentage.

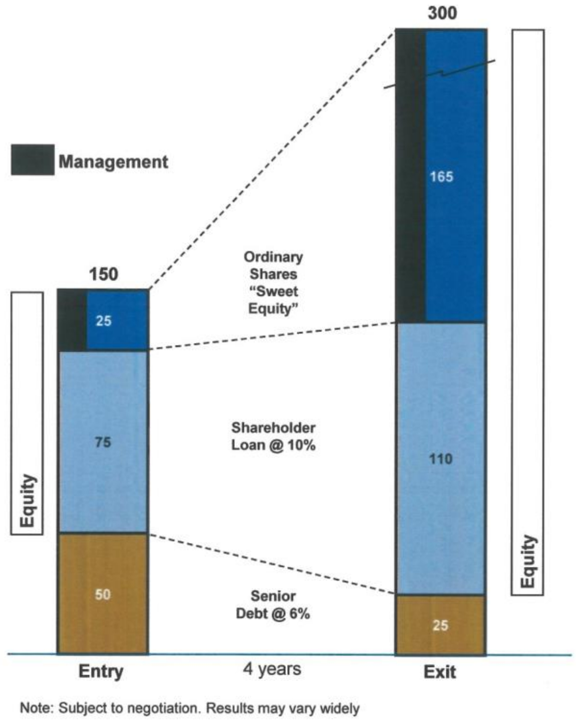
> *of course, what is interesting here is that the portion of the management in ordinary shares will be dramatically increased compared to the overall investment amount invested by the management, and the investment fund.*
>
> (Appendix A.7, p.114)

However, if the company underperforms and the EV decreases, then the EqV will also decrease, as it is junior to the debt which has to be paid first on exit; the management might even make a loss on their initial investment as the value of ordinary shares lowers. It is important to note that the PE has also invested into ordinary shares, in order to comply with thin capitalisation rules – which essentially restrict the amount of leverage a company can have – and that they make sure that their equity is not junior, so they will invest as a creditor. “It will be, of course, junior to the banks but at least it will be senior to equity holders.” (Appendix A.7, p.132)

This mechanism seems to agree with Baker, Jensen and Murphy (1988) who discuss how, through LBOs and by having management invest in company, promotion-based compensation systems can be replaced as their ROI is multiplied if they – and their company – perform well. It also agrees with Murphy’s (2012) observation that having management holding a portfolio of stock-related instruments is the best way to align the wealth of management and shareholders and solve the “agency problem”.

An illustration of the gains management can obtain with Sweet Equity is shown in Figure 5.6, with Figure 5.7 showing how the mechanism has a higher risk profile, with management eventually losing their whole investment.

Figure 5.6 – Illustration of potential Sweet Equity upside



Equity Value - Entry

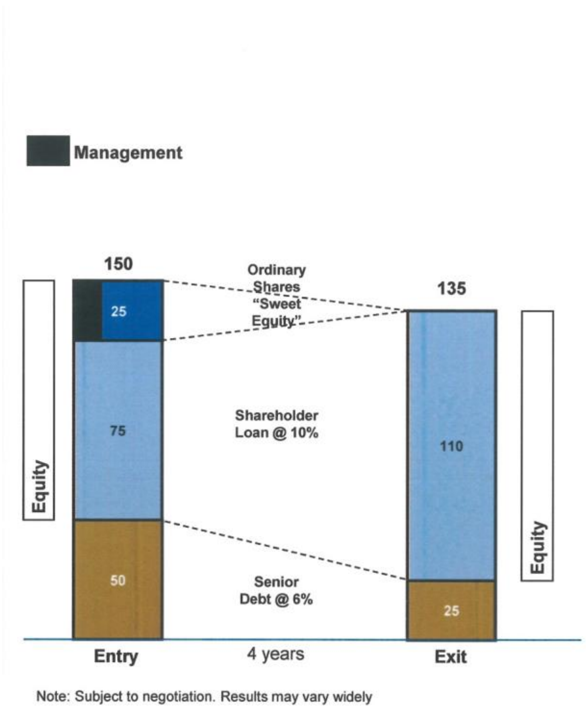
	Mgt	PE	Total
Ordinary shares	2 (8%)	23 (92%)	25
Shareholder loan	0	75	75
Total	2	98	100

Equity Value - Exit

	Mgt	PE	Total	
Ordinary shares	13 (8%)	152 (92%)	165	X6.6
Shareholder loan	0	110	110	X1.47
Total	13	262	275	X2.8
	X 6.6	X2.7		

(Confidential Source, 2011)

Figure 5.7 – Illustration of Sweet Equity's higher risk profile



Equity Value – Entry

	Mgt	PE	Total
Ordinary shares	2 (8%)	23 (92%)	25
Shareholder loan	0	75	75
Total	2	98	100

Equity Value - Exit

	Mgt	PE	Total	
Ordinary shares	0	0	0	X0.0
Shareholder loan	0	110	110	X1.47
Total	0	110	110	X1.47
	X 0.00	X1.47		

(Confidential Source, 2011)

So, to summarise this mechanism:

> *Our rule-of-thumb is that if your performance measure, IRR or money multiple, whatever, your measures are better than the fixed rates, then you will get a good portion of the package*
>
> *….If you perform bad, i.e. if your IRR is below the fixed rate, then you lose all of your investment.*
>
> (Appendix A.7, p.116)

MIPs should be limited to 15-20 managers in order to ensure effectiveness, as otherwise the value becomes too diluted; they are not effective with every type of management, as some managers do not like to be "stuck" in a company or would rather have compensation in cash-form rather than equity-linked, which again might be sector dependent.

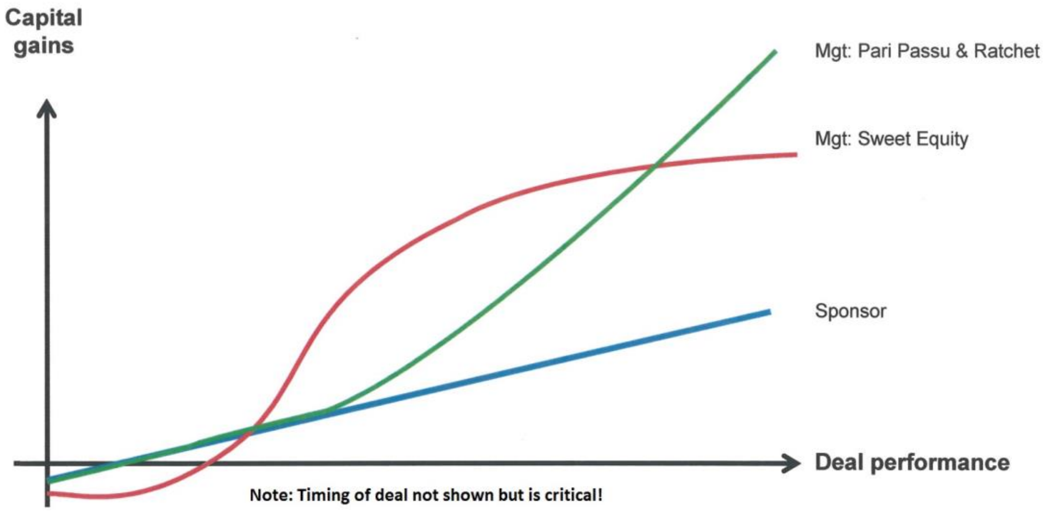
Currently, the Sweet Equity structure appears to be "bullet-proof" and – unlike the RSM structure – uncontested by the French tax authorities as these cannot challenge ordinary shares or the way the management decides to structure their package.

> *it's very difficult for them to claim that there is like an advantage that has been granted to or awarded to the management, or to say that it's a sort of disguised employment benefit. Because it is not… It's just something we have structured in a way that we believe it to be efficient. And it is very difficult for them to challenge it.*
>
> (Appendix A.7, p.116)

Sweet Equity packages shall obviously be designed within certain limits; there is a common understanding amongst lawyers and PE funds as to the limit of ordinary shares the management can acquire; at "90%, it's very obvious that, well the fund is just structuring it in a way that will enable you to capture a greater return compared to your overall investment" (ibid).

A comparison of the two mechanisms described – Ratchet v Sweet Equity – is illustrated in Figure 5.8 below.

Figure 5.8 – Comparison of RSM and Sweet Equity gains as value increases



(Confidential Source, 2011)

It is also important to note that most recent deals do not like to use warrants and options as these require capital to be set aside by management in order to exercise call rights, rather choosing to work with preferred shares or shareholder loans. This seems to indicate a decrease in the usage of those instruments to structure MIPs, particularly for LBOs, as also suggested by Murphy (2013) in Figure 2.2.

5.2.3. Anti-Dilution Measures

The findings seem to indicate that a very important – even fundamental – aspect to ensure the protection of management, and therefore that they remain motivated and focused on increasing company value, is to have anti-dilution measures put in place. These are especially important if the PE is planning many "bolt-on"[9] acquisitions while Management would rather avoid acquisitions with equity because of its dilution consequences.

This is easily avoided with RSMs, which are based on an absolute percentage on capital gains and not linked to an initial investment (although – note the example given earlier – the PE fund might try to "cheat").

A different approach must be taken for Sweet Equity. Even though most companies and countries grant statutory preferential rights to existing shareholders on new share issues, (shareholders – which in LBOs are basically controlled by the PE fund – can, with a majority vote greater than 75% in this

[9] "A bolt-on acquisition refers to a company that is added by a PE firm to one of its platform companies." (Divestopedia.com, 2016)

case), decide to waive the preferential rights. Thus management would be diluted and lose a portion of gains on exit. There should therefore exist three provisions ("The Holy Trinity") to ensure protection against dilution (Appendix A.7,p.123):

1. Force PE to invest at the then "fair-value" and not at "closing value" (value when deal was struck)
2. Make sure management has preferential rights on new share issues (both statutory and contractual)
3. Invest new funds into ordinary shares and FRI in same proportions as initial investment.

The first provision prevents shareholders from getting an immediate value-loss if they invest "mid-LBO", as the value of the company should be higher – which is the fundamental aim of an LBO – and therefore an investment made at the beginning of the project will be immediately diluted.

The second provision ensures that at least the management have preferential rights – even though they are not compelled to exercise – to acquire newly issued shares.

The third and last provision ensures that the management does not see their ordinary shareholding percentage being diluted. If the investment fund had the right to invest 100% of the new capital exclusively into ordinary shares, then the management Sweet Equity would basically be ruined.

5.2.4. Value Creation

It is worth to briefly mention the three key factors to a successful LBO: EBITDA, multiple and Net debt. They were mentioned in the interviews (Appendix A.7, p. 129) and two of those are also explained and illustrated in Figure 5.1 and Figure 5.3.

Out of these, the management can only realistically control the EBITDA as the multiple and Net Debt (e.g. Vivarte, Appendix A.7, p.130) are respectively controlled by the market and the PE fund. The success of the exit strategy is hence often beyond the management's control and therefore MIPs, which are only based on some of these factors, can be "unfair" and lead to disincentive effects that will be mentioned in later sections.

5.2.5. Difference to Companies not under LBO

Previous chapters have already illustrated how LBOs work and how these differ from other types of M&As. Due to the different nature and scope of such transactions, the ways management is motivated and the contracts negotiated are also quite unique.

The main difference is the level of the return. The return of MIP in publicly listed companies is typically lower than that on LBOs.

> *It's just totally different. Totally different… I mean, you can really get rich if everything goes well with a PE house. In a public company you have shareholders, it's public by a sense so everyone knows how the management is incentivised, and that's something that usually they don't like because you have newspapers, you have trade unions.*
>
> (Appendix A.7, p.112)

It has previously been said that in LBOs the management has either a good base package or a good bonus scheme, but cannot have it both ways. There are, however, various examples of public companies where managers have both, namely blue-chip companies, although the total potential benefits are typically lower than on LBOs.

When compared to strategic acquisitions or mergers, one should note that the remuneration schemes are completely different. In a PE an investor is injecting money, unlike a strategic acquisition where the deals are often done on a "shares-for-shares" exchange basis (Appendix A.7, p.91). Additionally, strategic acquisitions do not normally have incentive packages like those offered in LBOs and therefore managers are often "very afraid and fear "strategics" because "they know that they are going to lose everything…. because no package will be implemented" (ibid.).

When they exist, MIPs in public companies have differentiated structures, as it is hard for these to be based on return since the share price is constantly fluctuating and therefore shareholders who have invested at different points in time will have different baseline EVs. It is therefore more common to find LTIPs in public companies, which may also be based on financial instruments like preferred shares and stock options that will be triggered at the achievement of certain performance milestones. In this way, a bonus (like in the RSM scheme) is partially replicated but management is not entitled to a portion of shareholder capital gains.

5.3. Vesting Periods

Of extreme importance when operating the mechanisms described, is the duration of the LBOs as some MIPs are very time-sensitive. Apart from the increase in risk associated with time and the potential change in exogenous factors such as demand and multiples, which are market dependent, the accrued interest on FRI can destroy the value of the MIP as LBO duration increases. This can also be understood by keeping in mind the fundamental M&A Equation 5.1.

Equation 5.1 – Fundamental M&A Equation

$$EqV = EV - Net\ Debt$$ **Equation** 5.1**)**

As the value of the FRI (part of Net Debt) increase, assuming the EV remains constant, the EqV will decrease. This is because FRI are senior to ordinary shares and need to be paid out first; therefore, if the EV does not grow sufficiently, the value created will be absorbed by the FRI and leave very little of the remaining EV to be payed-out to the ordinary shares. A very simple example of this, which the author constructed using Microsoft Excel, is illustrated in Table 5.1 and Table 5.2.

Table 5.1 – Base values for Sweet Equity Examples

Investment Amount	**€ Millions**	**Inv. %**	**Ordinary Shares**		**FRI**	
PE	200	96.2%	30%	60	70%	140
Management	8	3.8%	70%	5.6	30%	2.4
			PE	**91.5%**		**98.3%**
			Management	**8.5%**		**1.7%**

ENTRY	**€ Millions**
EBITDA at entry	29.7
EBITDA multiple at entry	7
EV at entry	208
Net Debt at entry	142.4
EqV at Entry	65.6

Table 5.2 – Yearly evolution of Sweet Equity for Scenario 1 (7% EBITDA growth)

FRI interest rate (cumm.)	**11%**								
Yearly EBITDA growth	**7%**								
Valuation (x EBITDA)	**Y0-Y7: 7x**								
Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	
EBITDA growth (x times)	1	1.07	1.14	1.23	1.31	1.40	1.50	1.61	
EXIT									
EBITDA at exit	29.7	31.8	34.0	36.4	38.9	41.7	44.6	47.7	
EBITDA multiple at exit	7	7	7	7	7	7	7	7	
EV at exit	208.00	222.56	238.14	254.81	272.65	291.73	312.15	334.00	
Net Debt at exit	142.40	158.06	175.45	194.75	216.17	239.95	266.35	295.65	
EqV at exit	65.60	64.50	62.69	60.06	56.47	51.78	45.80	38.36	
Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	
Proceeds to Management									
FRI	2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98	
Equity	5.60	5.51	5.35	5.13	4.82	4.42	3.91	3.27	
Total	**8.00**	**8.17**	**8.31**	**8.41**	**8.46**	**8.46**	**8.40**	**8.26**	
Proceeds to PE									
FRI	140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66	
Equity	60.00	58.99	57.34	54.93	51.65	47.36	41.89	35.08	
Total	**200.00**	**214.39**	**229.83**	**246.40**	**264.18**	**283.27**	**303.75**	**325.75**	
Management ROI	0%	2%	4%	5%	6%	6%	5%	3%	
PE ROI	0%	7%	15%	23%	32%	42%	52%	63%	
Debt Evolution Calculation									
	Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Management FRI value		2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
PE FRI value		140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
	Total Debt	**142.40**	**158.06**	**175.45**	**194.75**	**216.17**	**239.95**	**266.35**	**295.65**

This illustrates a situation similar to what happened with Elis, a company that had performed well but whose debt structure was too heavy and therefore no one wanted to buy it. The company could not be "LBO'd" once again, which appears to be the preferred exit method nowadays based on the quantitative findings and on the evidence by Kaplan and Strömberg (2009) (Figure 1.3). Therefore, the management was "stuck" for 8 years before the PE house decided to exit through an IPO, in order to avoid further equity losses. In this scenario, the FRI had captured most of the value of the company and the performance was not sufficient to counteract the compounded interest, hence the management makes a "loss" (when the cost of investment is taken into account) but the PE makes a healthy profit regardless.

Although this type of MIP can have a negative motivational effect on management if the vesting period begins to be too long, it will potentially incentivise the management to achieve rapid growth (Boucly, Sraer and Thesmar, 2011) in order to exit earlier and obtain a greater return before the FRI compounded interest begin to have a negative effect. The important point however, is that the management should be made aware of this effect before they agree to this type of MIP.

Table 5.3 and Table 5.4 illustrate how the higher EBITDA growth will compensate or even outweigh the FRI compounded interest effect, leading to very attractive ROIs for both management and PE.

Table 5.3 – Yearly evolution of Sweet Equity for Scenario 2 (11% EBITDA growth)

FRI interest rate (cumm.)	**11%**
Yearly EBITDA growth	**11%**
Valuation (x EBITDA)	**Y0-Y7: 7x**

Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
EBITDA growth (x times)	1	1.11	1.23	1.37	1.52	1.69	1.87	2.08
EXIT								
EBITDA at exit	29.7	33.0	36.6	40.6	45.1	50.1	55.6	61.7
EBITDA multiple at exit	7	7	7	7	7	7	7	7
EV at exit	208.00	230.88	256.28	284.47	315.76	350.49	389.05	431.84
Net Debt at exit	142.40	158.06	175.45	194.75	216.17	239.95	266.35	295.65
EqV at exit	65.60	72.82	80.83	89.72	99.59	110.54	122.70	136.20
Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Proceeds to Management								
FRI	2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
Equity	5.60	6.22	6.90	7.66	8.50	9.44	10.47	11.63
Total	**8.00**	**8.88**	**9.86**	**10.94**	**12.14**	**13.48**	**14.96**	**16.61**
Proceeds to PE								
FRI	140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
Equity	60.00	66.60	73.93	82.06	91.08	101.10	112.22	124.57
Total	**200.00**	**222.00**	**246.42**	**273.53**	**303.61**	**337.01**	**374.08**	**415.23**
Management ROI	0%	11%	23%	37%	52%	69%	87%	108%
PE ROI	0%	11%	23%	37%	52%	69%	87%	108%

Debt Evolution Calculation									
	Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Management FRI value		2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
PE FRI value		140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
	Total Debt	**142.40**	**158.06**	**175.45**	**194.75**	**216.17**	**239.95**	**266.35**	**295.65**

Table 5.4 – Yearly evolution of Sweet Equity for Scenario 3 (14% EBITDA growth)

FRI interest rate (cumm.)	**11%**
Yearly EBITDA growth	**14%**
Valuation (x EBITDA)	**Y0-Y7: 7x**

Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
EBITDA growth (x times)	1	1.14	1.30	1.48	1.69	1.93	2.19	2.50
EXIT								
EBITDA at exit	29.7	33.9	38.6	44.0	50.2	57.2	65.2	74.4
EBITDA multiple at exit	7	7	7	7	7	7	7	7
EV at exit	208.00	237.12	270.32	308.16	351.30	400.49	456.55	520.47
Net Debt at exit	142.40	158.06	175.45	194.75	216.17	239.95	266.35	295.65
EqV at exit	65.60	79.06	94.87	113.41	135.13	160.53	190.21	224.83

Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Proceeds to Management								
FRI	2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
Equity	5.60	6.75	8.10	9.68	11.54	13.70	16.24	19.19
Total	**8.00**	**9.41**	**11.06**	**12.96**	**15.18**	**17.75**	**20.73**	**24.18**
Proceeds to PE								
FRI	140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
Equity	60.00	72.31	86.77	103.73	123.59	146.83	173.97	205.63
Total	**200.00**	**227.71**	**259.26**	**295.20**	**336.12**	**382.74**	**435.83**	**496.30**

Management ROI	0%	18%	38%	62%	90%	122%	159%	202%
PE ROI	0%	14%	30%	48%	68%	91%	118%	148%

Debt Evolution Calculation									
	Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Management FRI value		2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
PE FRI value		140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
	Total Debt	**142.40**	**158.06**	**175.45**	**194.75**	**216.17**	**239.95**	**266.35**	**295.65**

It might be worrying to see that, according to the findings of this research – although from a finite number of sources – it appears that the lifetime of LBOs is increasing, which seems to contradict Or's (2016) article. What does seem to be apparent from the interviews is that vesting period is very sector dependant, with sectors such as food and agriculture – which JBE are involved in and require high CAPEX – tending to have longer vesting periods in order to recover the higher investments.

5.4. Flexibility

Another factor that emerged from the research and appears to play a very important role in ensuring the effectiveness of MIPs, in particular preventing these from having a disincentive effect, is flexibility.

Occasionally exogenous factors, such as a recession or a fall in oil prices, can cause the performance of a company to fall. This links to Holmstrom's (1979) contractual theory, discussed in the "Literature Review" that predicts that pay-for-performance compensation should not depend on factors beyond the management's control. If this is the case and the MIP is based on the managers meeting KPIs, which are no longer attainable due to these factors, then it can have a demotivation effect and ultimately lead to managers abandoning the project (Appendix A.6, p.106).

This contradicts the findings by Sloan (1993), who provides evidence to support the hypothesis that earnings-based incentives help to protect investments from the volatility of the stock market caused by market wide factors. He claims that this happens because earnings are related to the firms' change in value (e.g. EBITDA multiple) and are less sensitive to market-wide movements in equity value, but he does not take into consideration that the multiple will most likely also vary, depending on market sentiment.

Being flexible in terms of the MIP put in place is one way to prevent this, another being the quest for management input in the design of the MIP – in the form of budget or business plan construction for example (Figure 4.2).

Flexibility means allowing the MIP to be adjusted in the eventuality that, due to critical external factors, the milestones and performance measures that trigger the compensation are basically unattainable; this might mean that the benchmarks are "reset" to more realistic values.

As an example, say that the management is rewarded on exit if the company is sold at a certain EBITDA multiple-based value but, due to a changing market sentiment, the valuation multiple for the industry decreases; there is nothing the management can do to affect the proposed multiple, even in case of an excellent EBITDA performance (e.g. Table 5.5).

Table 5.5 – Effect of decrease in EBITDA multiple even with high growth

FRI interest rate (cumm.)	**11%**
Yearly EBITDA growth	**14%**
Valuation (x EBITDA)	**Y0-Y1: 7x**
(changing market conditions)	**Y2-Y3: 6x**
(changing market conditions)	**Y4-Y7: 5x**

Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
EBITDA growth (x times)	1	1.14	1.30	1.48	1.69	1.93	2.19	2.50
EXIT								
EBITDA at exit	29.7	33.9	38.6	44.0	50.2	57.2	65.2	74.4
EBITDA multiple at exit	7	7	6	6	5	5	5	5
EV at exit	208.00	237.12	231.70	264.14	250.93	286.06	326.11	371.77
Net Debt at exit	142.40	158.06	175.45	194.75	216.17	239.95	266.35	295.65
EqV at exit	65.60	79.06	56.25	69.39	34.76	46.11	59.76	76.12

Project Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Proceeds to Management								
FRI	2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
Equity	5.60	6.75	4.80	5.92	2.97	3.94	5.10	6.50
Total	**8.00**	**9.41**	**7.76**	**9.21**	**6.61**	**7.98**	**9.59**	**11.48**
Proceeds to PE								
FRI	140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
Equity	60.00	72.31	51.45	63.46	31.79	42.17	54.66	69.62
Total	**200.00**	**227.71**	**223.94**	**254.93**	**244.32**	**278.08**	**316.52**	**360.28**

Management ROI	0%	18%	-3%	15%	-17%	0%	20%	44%
PE ROI	0%	14%	12%	27%	22%	39%	58%	80%

Debt Evolution Calculation									
	Duration (yrs)	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Management FRI value		2.40	2.66	2.96	3.28	3.64	4.04	4.49	4.98
PE FRI value		140.00	155.40	172.49	191.47	212.53	235.91	261.86	290.66
	Total Debt	**142.40**	**158.06**	**175.45**	**194.75**	**216.17**	**239.95**	**266.35**	**295.65**

5.5. Trust

Trust is the main overarching theme that emerged from the qualitative analysis. It appears to be key to ensure the motivation as well as the alignment of management and PE fund goals. Clarity of the goals and how these relate to compensation, support and involvement from the PE fund, and ensuring interests remain aligned, all seem to be at the basis of trust.

There are a few steps that can be taken by the PE fund in order to promote mutual trust (Figure 4.2), most of which have already been mentioned in previous sections. The involvement of management in the design of key performance-related elements such as the budget and the business plan, and the clear linkage of these elements to their MIP, ensures that there is no ambiguity as to what the management is entitled to and the influence they have on their level of reward. Participation of members of the PE house on the Board allows for a timely monitoring of the company performance and facilitates the provision of guidance to the management. The buy-in, both in material terms by investing in the deal, and in immaterial terms through the full-commitment to the set goals, is fundamental and should be done by both parties, in order to avoid “passive PE management” (Appendix A.4) or the “management being unable to fulfil their purpose”.

It is also paramount that the PE house honours their agreements with management and does not try to "cheat" them through valuation tricks or by playing with ambiguous earn-out mechanisms.

5.6. Management Retention

It seems to be common understanding that incumbent management is maintained after an acquisition, unless it is extremely under-qualified or lacks the required competences – which might happen if the company goes through many LBO rounds and experiences a huge evolution which outgrows the management's skillset – but this should be determined during the DD stage. Rather than changing the management in order to execute the business plan, their existing MIP is changed (Peck, 2004), so as to be aligned with the new interests and goals of the PE. There is also a closer monitoring by the PE, who should normally do so by sitting on the Board of the acquired company. These findings seem to agree with Peck (2004) and the conclusion that "sticks" tend to substitute "carrots", rather than complement them, and how internal monitoring by the Board is a more effective mechanism to improve management efficiency than externally imposed discipline from debt holders.

It is felt that monetary compensation is certainly not the only factor that motivates management and that the mission and mutual trust are vital to the smooth operation of a LBO (Appendix A.4, Appendix A.5); although good MIPs do not necessarily create loyalty, especially if the non-monetary factors mentioned are not in place, they are nevertheless very effective at retaining management (Appendix A.7).

A story was recounted of how there was a GM that used a lot of "stick" and was tough on the management, but how the management team persevered as they had very good packages and wanted to earn a significant upside on exit, which they would forfeit if they left the company.

We can easily infer the leverage that a correctly designed MIP can have and its importance in the success of LBO deals.

5.7. Cross-Country Differences

Finally, one of the aims of this study was to attempt and identify differences in MIPs between countries, and the reason why these occur.

It was already mentioned that taxation is a key factor to take into consideration when designing a MIP. In fact, taxation is the reason why RSM ceased being used in France and also appears not to be popular in Germany, Italy or Spain (Appendix A.7, p.118). However, it is still very popular in the UK, not only because – as it appears – many of the local LBO deals do not require the management to invest, but certainly because of the "entrepreneur relief programme" (GOV.UK, 2016), which greatly reduces the taxation on this mechanism.

In contrast, it appears to be that in Germany

> *There is no debate! You have to implement a management package with a sweet equity mechanism. Because a ratchet instrument doesn't even work... Well, even if you value correctly your option – well… and as we mentioned many times it is always something that can be challenged – even if you have an expert report etc. etc. it doesn't change a thing. Ratchet doesn't work! That's it.*
>
> (Appendix A.7, p.118)

There was also a brief mention of the range of financial instruments used in different countries and how for example in Luxembourg alphabet shares[10] and other financial instruments are profusely used, as these may be considered debt instruments in Luxembourg while they are equity instruments in the US.

> *The use of a number of classes of alphabet shares of this nature allows the vehicle to redeem individual classes of those shares at appropriate points in time so as to effect transfers of value, by means of redemption payments to shareholders, following the receipt of value from the underlying asset pool. Such redemption payments do not attract a withholding tax under Luxembourg law, if properly structured.*
>
> (Ogier.com, 2016)

Therefore, we can see how this again relates to the issue of tax-efficiency. In Luxembourg the qualification of these instruments seems to very subtle and "in a sense you can do whatever you want in Luxembourg" (Appendix A.7, p.116).

[10] This technique involves the issuance of several classes of shares whose economic rights are not correlated to only certain portfolio assets, but rather apply to a pool of assets as a whole and/or to specific investment periods. (Ogier.com, 2016)

This chapter has highlighted the most relevant findings from the research and tried to explain their importance in the design of MIPs and therefore the motivation of management and the value creation of the company. Where appropriate, the findings were also compared and contrasted with previous findings from the literature review chapter, sometimes agreeing with and sometimes contradicting previous research. The final chapter will summarise the findings and discussion in the form of a Conclusion and attempt to demonstrate how this study contributes to research and to the vastly unexplored subject of LBOs.

6. Conclusions

This chapter will summarise the conclusions drawn from the findings and discussion chapters. The structure of this chapter will be such as to initially cover what this study suggests to be the concluding answers to the research questions, it will then cover other findings that were not considered at the outset of the research, followed by suggestions for future research to be conducted on this topic, and finally identify the limitations of this study.

6.1. Research Questions

The most commonly used mechanisms, especially in France, for firms under LBO are the RSM and the Sweet Equity. There was also a brief mention of a “Macron Free Share” mechanism (after François Hollande’s Economics Minister, M. Emmanuel Macron), but its structure appears to be very complex and could not be clearly explained by the source. These appear to be different from the structures that emerged from the literature review, which shouldn’t come as a surprise considering such mechanisms were basically designed for public companies.

RSM’s usage has greatly decreased in France, as it is heavily contested and taxed and has caused public uproar, but is still used in the UK.

This has made Sweet Equity the most used mechanism at the time this paper was written and for the time being appears to be “bullet-proof” in terms of contesting by the tax authorities.

Anti-dilution mechanisms are required in both cases, to ensure both their effectiveness and the protection of the management. The three mechanisms suggested are:

4. Force PE to invest at the then “fair-value” and not at “closing value” (value when deal was struck)
5. Make sure management has preferential rights on new share issues (both statutory and contractual)
6. Invest new funds into ordinary shares and FRI in same proportions as initial investment.

Regardless of the range of possible analysis and opinions, **this study concluded that the main endogenous factors contributing to the success of a LBO project reside in a close and well matched communion of objectives between the PE and the Management and in a well-balanced, tax-efficient, incentive structure that maintains the existing (pre-LBO) management compensation packages, while ensuring a significant share in the “windfall profits” at exit.** This should be irrespective of eventual dilutions due to capital increases, acquisitions or other, and should also be flexible to adjustments in the eventuality of exogenous events such as a fall in commodity prices or a financial crisis.

Also discussed was how an extended LBO lifetime might negatively impact management compensation and even lead to a negative return on investment as the Enterprise Value is absorbed by the Fixed-Rate Instruments in a Sweet Equity structure, greatly impacting the Equity Value.

The study also concludes that there are differences in LBO structures between countries such as France, UK, Germany and Luxembourg and how these are mainly due to differences in their tax regimes and in the way they categorise financial instruments.

The research also seems to indicate that there is no standard vesting period for LBO transactions, which are rather sector specific. However, it does seem to suggest that the vesting periods have been increasing.

6.2. Additional Findings

The “mantra” for LBO transactions appears to “alignment of interests”, with “trust" being one of the key elements for success.

Efficient management’s motivation should therefore comprise their continued commitment to the project through self-motivation and a clear drive towards common objectives, together with the reasonable satisfaction of human greed in the form of a commensurate premium for a well done job (the “carrot”), with the loss of employment or expected benefits (the “stick”) being seen as the weapon of last resort in case of clear misalignment with the common objectives or underperformance in the fulfilment of one’s set goals.

6.3. Limitations

A key limitation of this study is that the findings and conclusions, although cemented on an exhaustive literature review, are objectively based on data gathered from only four sources. Therefore and regardless of their professional background and credibility, the validity of the findings might be disputed.

Additionally, the research also intended to try and establish a link between pay and performance. However, due to the sensitivity of the data, the author was unable to obtain data on the performance evolution of the companies analysed, which could have allowed for a deeper look into such possible link.

6.4. Future Research

Due to the focus of this research and the limited length of the study report, some of the themes and concepts that emerged from the qualitative research could not be explored into further depth. Nevertheless, the author hopes that some of the findings can perhaps be used as a basis for future research into the complex topic that is executive compensation and motivation.

Also, due to the rather qualitative nature of the research focus and the lack of data to measure performance – due to its sensitive nature – this study was unable to establish a mathematical link between pay and performance. However, if future researchers were granted access to performance measures of private LBO companies, such as EBIT and EBITDA evolution, then perhaps a mathematical analysis of the effectiveness of the MIP mechanisms could be established.

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Appendix A.1. Semi-Structured Management Questions

1. What is your experience in LBOs and/or M&As?
2. In your view, is there a “normal” vesting period and exit method?
3. Have you heard of “ratchet share mechanisms” and if so, what can you tell us about them? Are they commonly used in your experience?
4. Is it normal for management to also invest in company with the sponsor (i.e. PE/Investment fund)?
5. In your experience is management more closely monitored after an acquisition? If so, how? Milestones set? Reward or Punishment (“Carrot” or “Stick”) and why?
6. Do you have any experience in looking at or adjusting management compensation or MIPs? If so, can you tell us about it?
7. Any particular cases of successes/failures related to company performance and MIPs?

Appendix A.2. Semi-Structured MIP Lawyer Questions

1) Apart from the "retrocession bonuses" on exit, is there normally a major change (when compared to the pay prior to acquisition) in the "basic pay packages" i.e. salary (both in terms of cash and shares/options), perks etc.?

- Which of these elements changes the most and with what objective?

2) How do the MIPs compare with other (non-LBO) takeovers? Are they similar or is there a large disparity? if so, what and why?

- How have they changed throughout the years? E.g. pre-2008 and post

3) In many of the cases studied, there is a so-called "Ratchet Share Mechanism" put in place; what exactly does this method entail and what does it try to achieve? Is this quite a common practice in LBOs? Everywhere, or is it particularly common in some countries and / or time period?

4) Is there a "standard" vesting period (e.g. 4 years) that funds and PE houses in France try to go for nowadays? and how has this changed in comparison to previous years and decades? (increased / decreased?)

5) Is it common for the acquirer to put in new management after LBOs? Typically all, or just the CFO?

- How do you chose whether or not to put in new management?

6) Are there specific mixes of MIPs that are used in particular industries/sectors? And if so, why are these chosen for the particular case?

- How do you choose?

7) Do you know if there is a notable difference in MIPs put in place in France when compared to, for example, the US or the UK? If so, what are the main differences? (size, mixes, elements, etc.)

- Why is this?

8) Do you know of any “stick” (punishment) mechanisms put into place in case management underperforms (i.e. don’t meet milestones or internal targets?)

- How do these compare to their “carrot” counterparts?

9) In your experience, what seems to be the best motivator for management to perform according to shareholder’s targets? (pay, bonus, options, perks, other ?)

- How?

- Why? And why X compared to Y?

10) Do you ever find that management underperforms for unexpected reasons, even when quite generous MIPs are put in place? (perhaps bad work culture, lack of communication with shareholders / understanding of their real objectives, lack of trust etc.?)

- How?

- Why?

11) Do you have any particular success and/or failure stories that would help categorize what makes an MIP effective?

Appendix A.3. Management Retrocession Brackets

Company	Cash-on-Cash Return (CCR)	Project IRR	Retrocession to Management
Company A	1.6	-	1.4%
	1.8	-	6.3%
	2.0	-	9.8%
	2.2	-	12.1%
	2.4	-	14.3%
	2.6	-	16.1%
	2.8	-	17.5%
	3.0	-	18.7%
	3.2	-	19.6%
	3.4	-	20.4%
	3.6	-	21.0%
	3.8	-	21.0%
	4.0	-	21.0%
Company B	1.2	-	0.0%
	1.2	-	0.0%
	1.4	-	0.0%
	1.6	-	3.6%
	1.8	-	5.9%
	2.0	-	8.1%
	2.2	-	10.3%
	2.4	-	12.0%
	2.6	-	13.3%
	2.8	-	14.4%
	3.0	-	15.2%
	3.2	-	15.9%
	3.4	-	16.4%
	3.6	-	16.9%
	3.8	-	17.3%
	4.0	-	17.6%

Company	Cash-on-Cash Return (CCR)	Project IRR	Retrocession to Management
Company C	-	10.0%	2.7%
	-	12.5%	5.7%
	-	15.0%	7.7%
	-	17.5%	9.2%
	-	20.0%	10.2%
	-	22.5%	11.0%
	-	25.0%	11.7%
	-	27.5%	12.2%
	-	30.0%	12.6%
	-	32.5%	13.0%
	-	35.0%	13.3%
Company D	-	7.5%	-3.1%
	-	10.0%	1.8%
	-	12.5%	4.7%
	-	15.0%	6.6%
	-	17.5%	8.0%
	-	20.0%	9.0%
	-	22.5%	9.8%
	-	25.0%	10.4%
	-	27.5%	10.9%
	-	30.0%	11.3%
	-	32.5%	11.6%

Company	Cash-on-Cash Return (CCR)	Project IRR	Retrocession to Management
Company E	1.5	-	5.0%
	1.8	-	7.5%
	2.0	-	12.5%
	2.3	-	14.5%
	2.5	-	16.0%
	3.0	-	17.5%
	4.5	-	20.0%
Company F	1.6	10.0%	5.0%
	2.1	15.0%	10.0%
	2.3	20.0%	15.0%
	2.6	25.0%	20.0%
	2.9	30.0%	25.0%
Company G	Unknown	Unknown	Unknown
Company H	-	15.0%	0.0%
	-	17.5%	10.0%
	-	20.0%	12.5%
	-	22.5%	15.0%
	-	22.5%	17.5%
Company I	-	10.0-15.0%	15.0%
	-	15.0-20.0%	20.0%
	-	20.0-25.0%	25.0%
	-	25.0-30.0%	30.0%
	-	>35.0%	35.0%

Appendix A.4. Interview Transcript 1 – Calash (1)

Interviewer:	Francesco da Costa Gatta (FG)
Location:	University of Edinburgh Business School
Interview Subject:	Anonymous A (Mr. A)
Company:	Calash
Position:	Director
Offices:	Aberdeen, London, UK
	Sydney, Australia
Type:	one-on-one
Duration:	30 minutes
Date:	Tuesday, 2nd of August 2016

FG: Thank you for taking time to meet with me today. So, just before I start I wanted to ask you if it's ok with you for me to record this conversation, so that I can then write a transcript for my dissertation?

Mr.A: Yes.

FG: If at any point you would like me to stop recording, then please just let me know and I'll pause the recording. Is that ok?

FG: Yes. That's fine.

FG: What is your experience in LBOs or M&As?

Mr.A: Apart from advising PE with Calash, when I worked at Murray we were run by a Private Equity for a Global Buy-and-Build for a small business in Scotland. We then made an acquisition in Singapore, we made an acquisition in Yorkshire that got us access to the US and we had an acquisition lined up in Brazil – or entry to Brazil more accurately – when the debt came in. So that's Private Equity.

The other one in Private Equity was when I was CEO for WWW. That was also aligned in some respects to management too, in a different way. But in that we also made acquisitions through Joint Ventures in China, in the US and we set up joint ventures in quite a few other countries. We also divested two big divisions at the same time. So it's actually quite a challenge, particularly from the trustee angle, when you go into JVs or new countries with different cultures.

FG: Of course

Mr.A: Their alignment may be completely different to your alignment

FG: Of course, yes.

Mr.A: I… I had to contribute money in the "WWW Scheme", and it wasn't cheap… In the "XXX scheme" I didn't have to contribute anything at all. **My attitude to the success of either of these was no different.**

FG: Ok…

Mr.A: If there is the right people doing it… the cash that comes out of the bottom… to be honest, is not why I am doing it. It is the **challenge that is driving me, not the cash**. The cash is nice to have, and if you were to have **two equal opportunities, you'd probably go for the one with the cash**. And so, it is **not as simple as in the US where cash drives a lot of people,** because the **culture in the US is "money, money, money"**. I think it is **different in Europe**.

FG: Yes. Perfect, thank you. That is interesting to hear. Another aspect of my research is that obviously different people are motivated by different things…

Mr.A: Yes.

FG: So cash and massive bonuses, although some people might think: "obviously it is going to motivate them", like you said: "the US mentality", but if you are not in a good culture and you don't see yourself and others striving towards a common goal, then I guess…

Mr.A: I can give you a detailed example that I have, of **how we were affected by the money in real-life and how it changed behaviours.** But not recorded…

FG: Not recorded. No problem. Perfect, we can move onto that after. In your experience with Private Equity or Investments, is there a "standard" or common vesting period you normally try to go for? Personally, I did an internship in a Private Equity firm and I know that they always tried to exit within 5 years… And is there an exit method that is common to perhaps some industries more than others? Does it relate to industry, sector or is every deal different?

Mr.A: In my experience, if there is, I think every PE house is different. I think **PE houses historically wanted to get in and out in three years,** many of them. Some took a longer term view. I think the way the markets have changed – and they have changed in a number of different ways – so the markets are more difficult to get an exit time. **Sometimes by selling after 3 years you are actually giving value away. So I think people are more flexible**. Hmmm, it will obviously **vary by sector and by cycle times too**. Hmmm, I think also, the **availability of funds**… So now in PEs there is **generally too much money chasing too few good builds**. And also because of the scale of some of the funds, if you think of Charterhouse, which I know well, that's a good example in the UK. Even though they aren't the bluest of blue chips they have offices in London and they tend to do deals in excess of 500 Million, and above, and generally more towards 1 Billion, sometimes more. **The availability of these deals, in a way you can get value, is a lot less now**. And… I know there was an internal debate there on: should they change their approach, and should they lower down the size?

FG: Yes

Mr.A: The problem there is that that creates a lot more competition. You get people moving up, you get people moving down, you get people already there. And so the opportunity to find a good target is a lot greater. The consequences of that – and then you get 2008 happening – some funds who had been smart didn't have the fixes to do and they stayed there in the market. Some funds took a lot of fixes, and that then of **course changed the whole dynamic of "what's your exit time?"** Could be a **call to hold for longer, or would we have to get out?** And we actually see that right now with what's happened with the crisis.

FG: Yes

Mr.A: So some of the **funds were having to fundamentally change their strategies**. And… that **caused the multiples [exit multiples] to go up and awful lot**, which of course in turn has an impact: potentially you have to hold for a lot longer to get your value.

FG: Yes, of course

Mr.A: So it is actually **quite a complex mix of drivers. And that varies by sector too.**

FG: Perfect, thank you. In a lot of the companies I am analysing, they have a system in place called a "ratchet share mechanism". Is this something you have experience with? Is it common practice, in your view, here or anywhere in the World you may have worked?

Mr.A: I get it. I understand how it works, but I haven't personally been involved with it.

FG: Ok. You've already said that sometimes you have had to invest with the sponsors yourself, and other times no. Is it common practice for the sponsor to ask the management to invest with them, in order to try and align interests, or is it quite rare practice?

Mr.A: I think **it is common practice**. **Whether or not it is a, hmm, a good practice**… In one of mine I didn't have to invest at all. In one I did.

FG: Perfect. As you said: it didn't necessarily motivate you any more in one case rather than the other. Personally it was something else – **the mission** – that motivated you.

Mr.A: Yes. Exactly!

FG: Ok…

Mr.A: In fact, if anything, in the first one I got a higher salary and didn't have to invest. In the second one I got a lower salary, did have to invest and the upside was… potentially… marginally better than the first one. But not dramatically. I think there, you almost contrast the style of the organisations.

FG: Yes

Mr.A: One was more collegiate and the other was heavily fuelled by an individual who his purpose, apart from great public exposure, was… personal wealth. So there are quite different cultures that set through that. So **I think that the package itself can be important, but I think the environment of the owner, is more important.** So if for example if you take Charterhouse, that's got a great reputation of how it works with its management teams… and you take, ermm, I'm not quite sure what the reverse would be… But, **that would weigh much more for me than another 1 million pounds at the exit**. Because actually being able to **trust** the people your dealing with, and some of these guys are "financial engineers" who don't understand, or don't like bad news. And that then gets us to a much broader issue… which is **the PE model itself.** Because what's interesting about the PE model, which I've discussed with partners at Charterhouse and others, you know… They are essentially financial partners who will have some operating partners who they can call on periodically, but the financial partners will… Uhmm… Invest in a business, **they don't know the sector. They may invest in this sector but they are not experts in it, they rely on others… So they invest in the sector, they invest in the management team… they never sat in management teams before. So they may be in the partnership team, but they are not in a business management team… And they are asking that business management team – that they're selecting, who they think is good, and effectively they think is going to have an upside – to do something that has never been done before.**

FG: Yes…

Mr.A: So it's quite an interesting model.

FG: Yes

Mr.A: Where you don't understand the industry. You've never run people before. You're prying yourself publically on saying that you are going to ask a team to do something that has never been done before.

FG: Yes

Mr.A: So when you put that back into the model of, you know, that **there's too much money chasing too few opportunities** and you align that with the softer things… It's quite an interesting mix and if you were to look over the returns over the last, say 2008 onwards, versus prior to 2008, they are probably very different and by sector.

FG: Yes. And there is a lot more and not as good.

Mr.A: Yes, and that's when Calash comes in sometimes. And you know, if you broaden that out into some of the stories we are seeing right now, with new management teams who have never had to go out and sell. Who are having to, in the market size with everyone trying to buy and sell, they don't know what their USP is, they don't actually know their "elevator pitch" is. The **PE house doesn't fully understand the business and then chairman of the PE house is not supporting the management team. And so we [Calash] actually offer to turnkey a PE house's business, to bring that level of support to them.** The response was: "Oh no, we couldn't do that because that's what our role is supposed to be…"

FG: But if they can't do it, then…

Mr.A: I know. Which **goes back to that model itself.**

FG: Yes of course

Mr.A: When the pressure cooker is leaking left, right and centre… What do you really do?

FG: Yes extremely interesting, and I agree. You get people that basically look at numbers, analyse and think: "this could be a good opportunity!" And then try to find people who can run it for you, but without you being able to run them. Or maybe even being able to evaluate if what they are doing is appropriate and then expect returns in a short period time, perhaps in a market that is not even stable… Especially now, after 2008…

In your experience, after acquisitions, would you say that management afterwards is more closely and tightly monitored? Or is it kind of: "Carry on what you were doing", with internal milestones set?

Mr.A: I think it varies by PE fund. I mean, when you invest with a PE fund, the value you need to create is very difficult to execute… Say after an acquisition, **people tend to relax once the acquisition is done. Actually, that is the time to accelerate!** And that comes back to **leadership within the company that you've bought, or the effectiveness of your members on that board: Chair, Exec. Chair, whatever you put in.** And recently we have seen 3 investments where, even in this oil market, where I think the **PE houses have been absolutely passive** in an environment where they should be stepping in, partly **in supporting in management** and actually **driving change**. Because change wasn't happening and they are 2 years into the cycle, and they haven't changed a thing.

Mr.A: You know… I had conversations, Calash had conversations. Now, I don't know why. But **if you are a PE house, you have to go in and have an impact!**

FG: Yes. I mean, from my analysis and reading, part of the point of having a PE firm or a hedge fund buying you out is they can bring contacts, or new management or something to help with change and reach goals. If you can't then it goes back to what you are trying to achieve, and the whole way you operate. If you can't do this and you are just a passive investment bank, then you are not doing more than just buying shares technically…

Mr.A: Yes. And to actually follow them, to me, is fundamentally much more important than having some sort of financial incentive alignment. Because if you don't have that, everything else is irrelevant.

FG: Yes… If you are like: "Ok, this is what you get. Carry on with what you were doing…"

Mr.A: Yes, and if by any chance there's a bit of **luck** it works, then there is a **"big cheque"** for it. But it shouldn't be down to **luck**!

FG: Absolutely! Briefly on the same subject, but the reverse side of the coin, have you ever seen punishment to management? I'm not sure of what shape or form, but any time where… I don't know, management got fired for not performing well or…

Mr.A: Yes. I've seen people get fired. I've seen where people… People in the business have their strategy and the owners think of their own strategy… And there it is less about firing, it's more just an "agree to disagree" by exit.

FG: Ok…

Mr.A: And I have seen where **the nature of the challenge changes… But the incentivisation scheme doesn't.**

FG: Ok.

Mr.A: And so, it's **not so much that people are doing everything because of the money**. It's just that therefore when one doesn't change to align with the activities, then it doesn't become credible and **trust** breaks down doesn't it?

FG: Yes.

Mr.A: So I think that **trust and transparency to any incentivisation scheme is critical.** And I've been involved in one where there wasn't **transparency**… and when that eventually did come, it led to a breakdown of **trust**.

FG: Yes.

Mr.A: And that then goes to the heart of any relationship.

FG: Yes, perfect! Just one question before we move onto the example you were talking about… Do you personally have, I'm not sure if this is your role, but have any experience at looking (and adjusting perhaps) management compensation packages? Be it pay, bonuses, perks, whatever… Do you have experience yourself of doing that?

Mr.A: Yes. I mean, as a CEO I've overseen numerous different examples, both in public companies, private and private equity.

FG: Ok. Are these done post-acquisition? So gone in, looked at what the management gets and thought: "OK. This is what the management gets. OK, this pay is too high. Pay is too low. Got to change structure of the package. Too much bonus…" Or…

Mr.A: Well the XXX-YYY merger… That was a quite interesting one. YYY was a private business and XXX is a listed business.

FG: Yes

Mr.A: So the conditions are quite different in the two companies. And it was how over time you could align that. And in effect, I think what we did was it was all brought to line with the BAT package…

FG: Ok

Mr.A: Ermm… Very attractive (to put it mildly). But what **couldn't be aligned was pension schemes**… And the Rothmans guys have dramatically better pension schemes. Uhmm, we just had to live with that… That was the only way. You just sometimes have to accept that and if people don't like that, well then they can leave. There's not much you can do about something you can't change.

Another interesting one on the M&A side would be when you are making an acquisition in a different country or a different culture.

FG: Yes

Mr.A: So for example… you are… let me think of a good example. When I was working at ZZZ, we were wanting to set-up a Joint Venture in Chile with an individual.

Money goes out of the window because he's got a shareholding. And he's the GM and… I think my point here would be, you have to be flexible. Now I at the time, I sat at the negotiations and I'm still friends with the guy… And I think… he was such a hard negotiator because he knew that he was holding onto something that we wanted.

FG: Yes

Mr.A: And he will have made millions out of this… But he also drove really hard on his package and really hard on his bonus…. At what point do you just say: "Hang on a second… Wow!"?

FG: Yes…

Mr.A: But then what you got to do is… I think you just **have to do it on a case-by-case basis…** So: "Ok we'll "fence" you." But for all the other people in your business, we will say: "Right. That's what happens in Chile and that's what we'll benchmark against: the norms in Chile." If you want to offer-up some sort of shareholding package to them. Well that's a separate conversation entirely…

And yet, you then go to Indonesia where we set up a Joint Venture with a company. And you go with what's normal pay in Indonesia. Just because you have a PE basis, **you shouldn't impose that on a culture who doesn't understand it or want it.**

What can be challenging is if you go to the likes of China, where their whole attitude to everything is very, very different.

FG: Yes

Mr.A: And particularly if you are doing a JV with a business where the workers are probably treated and payed poorly… And there is a handful at the top, that will be absolutely harborous around it all. And you have to be very careful there… And that's one of the relationship issues with Joint Ventures… It's choosing the right one. So an acquisition – even in a "Third-World Country" – you have to make sure you are buying-in the right people. Because they are going to do what they want, regardless what you put in place. And that's a different level of challenge and at the end it goes again into the **fundamental of culture**. So it's around **transparency** and **trust**. Which again is **not to the heart of money incentive schemes.**

FG: Yes. So…

Mr.A: Here's an interesting example… probably a very unusual example: XXX bought through privatisation a company in the Ukraine. Just after we bought them, the then former General Director, who became the deputy GM and XXX put in their own person…

FG: Yes…

Mr.A: He **doubled the salaries of everyone. XXX didn't find out until 4 months later.**

FG: Ok…

Mr.A: So this is just an example of these **transparency** and **trust** issues you got to be clear on.

FG: Ok…

Mr.A: That's a really unusual example. If you are in Western Europe or North America or parts of South-East Asia, that wouldn't normally happen.

FG: And what was his motivation to do so?

Mr.A: It was to please them. It's not that he was a bad man…

FG: No of course.

Mr.A: But again that goes to an issue that's really important. If you're going to… an acquisition. I think you have to be really clear on the softer issues as much as the harder issues. **And how you merge two cultures. And that's one of the biggest issues of all.** To buy a US a company and integrate it into a British company is not easy … They just **operate very differently.**

FG: Yes

Mr.A: And it's **not just cash.**

FG: Yes. So for example Maslow said that the cash is basically the base. Obviously without it nothing is done, but it's not the most empirical. So you would say that trust and transparency in your experience…

Mr.A: I personally… **There's that PE model where you will get payed a lower salary than in working for a "Blue-Chip" or a multinational. But, you will get a slice of the shares, and therefore a big upside on the exit.**

Well, that depends on which "Blue-Chip" you are working for. And you can get packages that can be worth 500k to 1 million pounds a year in a "blue-Chip". And they will take somebody with similar experience and say: "we'll pay you 100k and you contribute 50k and you get maybe get an upside of 1 to 2 million in 3 years"

Where…. I don't like that because that 100 grand, you are getting me at a massive discount. And that to me doesn't seem **fair**. So, I mean each person will have their own view of what's the equilibrium.

FG: Yes of course.

Mr.A: And the other thing that… I'll come back to an example later on… Is if you've got real control of your destiny… The value of that future, revenue stream or cash stream, is actually discounted much more greatly in your view. So if you're **being pushed into a very low salary, I would tend not to take a job like that, because I think you are just after me cheaply.** And then you **want to change the strategy, but you won't to change the remuneration profile.** And what about if the strategy you've already got… So if it was my strategy and someone was brought in to change the strategy, that's different. So if it is an **MBO effectively, that a different setup to: "It's actually not worked. Will you come in and be the CEO?" Because then you have a lot less control.**

FG: Yes.

Mr.A: So I don't know how that fits in with what you are reviewing. MBI versus MBO?

FG: Well, some of the exit methods are through MBO. Yes, I'm looking at…

Mr.A: Even in a secondary buyout… **part of the value of the business is going to be its leadership team.**

FG: Yes absolutely.

Mr.A: And even if there is an earn-out period and there's a transition phase… and that's quite important. So say the top PE houses are looking to leave the group and make big money. The only way they can exit, is by having that plan coming through… **That inherent part of that sale plan must be negotiations of future incentives for the remaining team.**

They have to completely on board with that. And that goes back to **trust and transparency**.

FG: Perfect.

Mr.A: Another issue there was… where… I've learnt this the bad way… Where there are additional capital injections, that the **management doesn't agree with but the shareholder either has to do because of its banking relationships, or wants to do because it wants to change the strategy**. The management team can then get diluted.

And… If I was to do that again… I would only sign a deal where my….

FG: My **percentage was fixed**?

Mr.A: Yes.

And again that comes back to **trust and transparency** and the level that you **feel you are in control**.

FG: Perfect. I will now turn of the recording device [Microphone switched off for next part.

Appendix A.5. Interview Transcript 2 – JB Equity

Interviewer:	Francesco da Costa Gatta (FG)
Location:	JB Equity, 43 Charlotte Square, Edinburgh
Interview Subject:	Mr. Bor Boer (Mr.B)
Company:	JB Equity
Position:	Group CEO & Partner
Offices:	Edinburgh, UK
Type:	one-on-one
Duration:	30 minutes
Date:	Tuesday, 9th of August 2016

FG: Good morning Mr. Boer and thank you for taking time to meet with me and helping out with my dissertation research. So, just before I start I wanted to ask you if it's ok with you for me to record this conversation, so that I can then write a transcript for my dissertation.

Mr.B: Yes.

FG: If at any point you would like me to stop recording, then please just let me know and I'll pause the recording. Is that ok?

Mr.B: Yes.

FG: My dissertation basically looks at Management Incentive Packages after LBOs, and how it is that the management of the acquired companies is motivated in order to achieve certain goals and milestones set by the acquiring firm and essentially, sometimes "flip" the company in order to sell it after a relatively short period of time.

Having extensive experience in Private Equity, can you give me some insight into your "normal" acquisition methods?

Mr.B: So, most LBOs focus on **cost-cutting** in order to try and optimise company revenues and margins. JBE focuses on raising capital to grow the business. So for example there was a case where we raised money to grow, to double production, in order to sell more and use existing sales channels with the company and alike. The guy that we hired to do that was someone who was experienced in doing that.

FG: Ok.

Mr.B: And again, was well incentivised to achieve that. So, together we had a growth plan – let's say a business case – with annual or semi-annual milestones in terms of: increase in sales, increase in production and as well increase in growth margins. So very much a **growth story**.

FG: Perfect.

Mr.B: His package was based on meeting those milestones.

FG: Ok. That's one of the questions I have… From the readings and other interviews, I've seen that different Private Equity firms buy the company, come in and are very passive. They tell the management that they have to meet goals, but they don't really give them a plan or anything

Mr.B: Yes.

FG: They just tell the management: "This is what you have to do." But yes, ideally one would expect the Private Equity firm to come in, set-up a business plan with the management – if they bring in their own management then it's a bit different – and then set milestones, interesting that you said semi-annually or annually.

So basically you're saying that if he didn't meet these milestones then he would not get a bonus?

Mr.B: A bonus. Yes. Because you give a base package. In order to attract people you need to give them a fair base package.

FG: Yes

Mr.B: What we try to do as well is that person you'd hire would be part of putting the growth plan together right?

FG: Yes

Mr.B: Because **you need buy-in from them as well.** It's **all about accountability** as well. So then you can hold them accountable and say: "Well this is what we developed together", and obviously there is always room for… Because you can't control everything right?

FG: Yes

Mr.B: There is room for interpretation and for differences in terms of: "Ok. If you don't meet the growth we've anticipated" and there is a good reason for that like… I don't know, a crisis or something like that which is completely out of control, then you can always deviate from what you initially appraised. But I think that the initial idea is that you **align interests**…

FG: Yes

Mr.B: … And as well with the growth and get the buy-in. I mean, how we would work is the same reason, right? Most PE firms work in terms of: **when they get money, they get incentivised as well with a "carry" above a certain threshold.**

FG: Yes

Mr.B: Right. So in that sense, that is also an **alignment in terms of the interest of the investors and the PE firm.** So we **try to duplicate that as well with the management we hire.**

FG: Perfect! That is super helpful, thank you.

Mr.B: So sometimes what you could do as well… Or sometimes we get hired as well to for example implement the growth plan and we get rewarded with a percentage of… let's say a percentage of the growth proceeds of the additional sales.

FG: Yes

Mr.B: And then **part of that will be "kicked back" to the person who is doing that on behalf of us**.

FG: So who would you get rewarded by?

Mr.B: We get rewarded by the company. So they hire us…

FG: Ok

Mr.B: … and in return for that we **get an equity stake sometimes**.

FG: Ok

Mr.B: And we get **as well a cash component**.

FG: Ok. And then that is split between you and the management.

Mr.B: Correct.

FG: Are you in charge of bringing in new management or sometimes do you just leave the existing management?

Mr.B: Well we leave the existing management. But if we think that we need to change some parts of the management – specifically if looking at expansion and going into new markets and the reason why we are getting involved is the company acknowledges it is not their strength – then we would bring in that part of the management.

FG: Ok

Mr. Boer - So if it's commercial development, we would bring in someone who we think can execute that commercial development. And if we think the company is better off to strengthen their operational part of the business, then we would look for someone with that experience.

FG: Perfect. And, when you bring in management, say someone specialised in marketing or sales, does that normally come in addition to the existing management? Or has there been occasions where, I don't know… obviously the manager already there is underperforming and therefore you get rid of them and replace them?

Mr.B: Well… both. I think the way that we work – and that is not always the same as other PE firms – is that **the management we would bring, would be employed by us.**

FG: Ok. So in effect like a consultant.

Mr.B: Yes. Which means as well that **we keep them aligned with our interests.**

FG: Yes

Mr.B: And obviously for us it's an additional way to make additional money, because we would charge the company for that.

FG: A consultancy fee?

Mr.B: A consultancy fee and there is a margin in that. But we can as well **get very much the opportunity to align the interests with our interests. A direct say in that, right?**

FG: Perfect.

Mr.B: But that manager – that's only on the management level right? – that management could have a team, a sales team, which would employ for example another team, an operational team, which is employed directly by the company.

FG: Yes

Mr.B: But the management is employed officially then by us, as a consultant. Or we get the consultancy agreement to do that and we subcontract part of that to someone we identify to put in.

FG: Perfect, that's an interesting model I hadn't heard of.

Mr.B: If you would look at the target, sometimes what you would see is – and how we do it is slightly different from normal ones [PE firms] – but normal ones try to do the same thing by charging management fees right?

FG: Yes

Mr.B: To the company right?

FG: Yes

Mr.B: Consultancy fees, support fees etc. Most of the time, these are just ways to extract money.

FG: Yes.

Mr.B: Right. If you look at the content of what they are doing for that, you know providing services, all this... **It's really light. It's just a way to charge money, to get cash out of the company.**

FG: Yes.

Mr.B: Our model is slightly different. We properly employ people, there is a **real relationship.** And the reason for that is that, again **our business model is not so much on extracting cash**. If you look at how our return is made it is not so much…

FG: Fees?

Mr.B: It's not so much fees out of the company, not about getting as much cash out of the company as possible. **Not squeezing it dry.** Is to make sure it **grows and then getting a return out of that**. A return by **either selling at a better multiple** – a different multiple because you are a bigger company and have a much more robust business, so your multiple changes – and **by growing the EBITDA**. But that's **a different business model than what some other PEs have**, who are more like: "OK, this is the company. We **get out all the cash we have, and then we try to sell it at the same multiple or if we are lucky the market gives us a higher multiple**". But it's very much dependant on the market sentiment at the time, if they can get a higher multiple or not.

FG: Perfect. You mentioned buy-in from the management. Is this something quite common? I don't know if you meant that your external manager buys-in with you or the company you are providing a service to. Or do you get the management – which I assume sometimes is already bought-in through shares – to buy-in in order to, again, try and align the interests of everyone.

Mr.B: Yes. Exactly. I mean, we like to work with the management in order to develop the growth plan together, so that we have their "**buy-in**", lit… you know, so that everyone is aligned. And that **could be in the form of an additional cash contribution as well, but most importantly it's that in their mind-set they support what we think we can do. Because otherwise, it's never going to work.**

FG: And how do you guarantee that? Through trust?

Mr.B: Well, there is no way to guarantee that, but it's a way of **trusting and it's a lot to do with engagement**. So when you develop your growth strategies, you need to make sure that while doing it **everyone is engaged**. **Part of it has to do with incentives** as well. Again, it's different if you become the majority shareholder or you remain the minority shareholder, but that's where we'd generally like to become a majority shareholder. Then the existing management package has the same kind of **incentives, which are related to your business plan**, as what you want. **You can align those interest better.**

FG: Thank you. On the topic of Management compensation. Do you have experience, or have seen, the opposite to happen: for management to be punished if they underperform or don't meet certain milestones? Or is the punishment for not meeting the milestones just the fact that they don't get the bonus.

Mr.B: You don't get the bonus… I mean, I guess it's the same for regular employees right? **I don't think the "stick" works very well**, especially if you want to keep them. So **you just make sure there is no "carrot" then.**

FG: Perfect.

Mr.B: But no, I've never seen punishment… Yes, the **biggest punishment is that you fire someone.**

FG: Yes

Mr.B: Which would be the only punishment if it really goes wrong and you see it, then you would fire someone.

FG: But that's quite rare. Unless you completely…

Mr.B: Ehh, Yes… Pfff. Erm… It happens, but I think it's more that **when you do the investment at the start, you make an analysis: "Ok. Who can stay? Who is good? Who is bought-in and who understands it?" and you make those changes as fast as possible and then implement it, rather than somewhere along the line.**

FG: Perfect. From what Erik [Investment Manager at JB Equity] told me, compared to other Private Equity firms you have a longer time period to exit. Is there a "standard" time period that PE firms try to go for nowadays or does it always vary?

Mr.B: No, it varies. I mean, I'm surprised actually because I was talking to one of the companies we are looking at, which is currently PE owned, and those guys were looking at an **exit after 3 years. Which from my perspective is super-fast!**

FG: Yes.

Mr.B: That's an abnormal thing, so it very much depends. We would be more in the 5 to 7and again it very much **depends on the sector and what you are trying to do.** I mean, because we are very much **growth-oriented**, there is time you need to do that before you can see the results.

FG: Yes.

Mr.B: If for example you build a pig-farm, it takes 1 year-18 months before you have it built, you have it filled with pigs and grown up and **before you can see cash coming out of that**.

FG: Yes.

Mr.B: Now that's very different than if you do something, say **cost-cuts**, in 6 months' time you see the results.

FG: Yes.

Mr.B: So our investment periods – **our horizons – tend to be a bit longer.**

FG: Perfect. In a lot of the companies I am looking at, there's a so-called "ratchet-share mechanism" put into place. Is this something that you've worked with before?

Mr.B: Can you define it for me?

FG: Yes. So from what I understand it's a mechanism where you get warrants or share options, but they are only given if you meet predefined criteria or milestones.

Mr.B: Right. Well, we have it in terms of our carry. So we will have a minimum return requirement and then only above when we meet that, we get a percentage of the profit which is not shares but is just carry. For the management, in the sector we work in which is Food and Agri, it's **not very common. People would work more with bonuses and carry cash and maybe a carry component, rather than with warrants and doing it with shares of the company.** The reason for that is that we **tend to work with non-listed companies** anyways, so if there is **no liquidity in the shares** then what's your thing then? People understand as well: "If I meet certain criteria I get a bonus" and it may be related to something, rather than doing in shares and all that sort of stuff.

FG: Perfect.

Mr.B: And our exits **most of the times are not IPOs** or something like that either.

FG: Ok. So you're exits are normal by selling to another investor?

Mr.B: Yes. **Strategic and potentially to other financial investors**. But most of it has to do with the sector we are in, because food and agri, you know, is not so common that you go to the stock exchange and buy a stock of those. It's not like IT or software etc.

FG: Perfect. In terms of compensation, have you yourself ever gone in and looked at the compensation packages of existing management within the company and said you know: "This need to change and…"

Mr.B: I think as **part of our Due Diligenc**e, we would **review how management is compensation**, right?

FG: Yes.

Mr.B: And if we think because of the plans we have that needs to be adjusted, than we can adjust that. Aligning interest of management is something which is important and you would look at as part of your DD.

FG: Perfect.

Mr.B: … and what we see is that a lot of the management we get engaged with, again sector specific, is they **tend to be shareholders as well.**

FG: Ok.

Mr.B: Minority or sometimes **majority** owned and they are selling part, they are setting down part of their shares. So in that sense the **alignment of interest and packages is something which is important, but it is easier then as well because you are talking to a shareholder.**

FG: Yes.

Mr.B: So **he has a stake in creating more value to the business**. But the addition, which is different if you hire someone and then just give them bonuses and all those things, is that **the exit then becomes more of a point which you need to discuss with management**.

FG: Yes

Mr.B: You **need their "buy-in"** so to say. Does that make sense?

FG: Yes.

Mr.B: Rather than if you were to just hire management, incentivise them on a bonus-scheme and then they do the job and they are out.

FG: Yes

Mr.B: So the way you **engage management** then is slightly different.

FG: Perfect. So that's covered all my points… Do you have any particular cases of particular success and failures when it comes to motivating the management or entering a project where… I don't know… there was extremely clear communication with the management. They had a buy-in and there was regular meetings and therefore everyone was on-board. Basically in your opinion, what seems to work best for everyone to gain? For the company to grow, you to make a profit on exit, the management to possibly make a profit on exit…

Mr.B: I think that the main thing is making sure that whatever **performance metrics** you put in place, firstly they are **realistic** and secondly they **can be influenced by the people. By the management**. I don't know… Depends on the growth plan, so for example if you would expect a company to grow very much on the back of general market demand, and if for whatever reason that general demand market falls off **without the realm of influence of management**…

FG: Yes.

Mr.B: Then I'm not sure if you should put in a performance metric that is purely based on gross increase in sales.

FG: Yes.

Mr.B: But if **it's more margin related, or its market share or those kind of figures then you should tailor more to that point.** What I think is important as well is that **you be very transparent, up-front.** In the sense that when you set those targets, you **clearly explain to management what is expected of them and how they are rewarded.** Now, generally the people we tend to work with, they are not so much financially driven in the sense that they are very monitored on the day-to-day basis, how they are doing against versus their own performance prefects. And **I don't think you would want that as well.**

FG: Yes.

Mr.B: So if you would look at the variable component versus the fixed component. **In our industry the fixed component is still the largest part of the general compensation, and the variable component is a nice additional extra thing. Rather, than some other sectors where the variable component is the largest component of the package. But that is very much industry specific as well.**

And people tend to work more because they want to make it to success, you know? There is other ways to incentivise and other ways that drives people than just the package. Fortunately.

FG: Yes.

Mr.B: So it's a mix of that. But **whatever you put in place, it should make sense and should be perceived by the other person as making sense.**

FG: Yes. To go back, you were saying that performance metrics obviously need to be relevant and need to be achievable and controllable by the management. Say that you had a target say for cost-cutting for example, even though I know it's something you don't tend to do, or sales increase to this amount, and there is an external facto that happens and the compensation bonus was set based on these… Would you then go and change the bonus, say like: "It was meant to be set on this, but external conditions occurred therefore we are going to change it." Or…?

Mr.B: Well… If it results in, let's say**, a change of budget** and all those things, then yes you need to mend it. But that's where if you would define your performance metrics as well, you would say: "you get a certain bonus if you perform 5%, 10% above budget." Right.

FG: Yes

Mr.B: So that **budget**, you know what the general growth plan is but you **at least allow for a flexibility to adjust the budget, and budget is mostly set on a yearly basis by management – so they have an influence there – and then is approved by the board. Which again is us.**

FG: Yes.

Mr.B: So then you get into that… it's not like that when they say… especially when you have an investment horizon of 5-7 years, if you say: "well this is the plan. This is fixed and we are not going to change those things in the 5-7 years."

So yes, you would **allow for flexibility by putting it versus budget, and even metrics that have been approved in the budget.**

FG: Yes.

Mr.B: And then usually a **budget** is then approved on an annual basis and **initially proposed by management.**

FG: Perfect. I also read a paper in the literature I was studying, and some people made a point that you also made, that if external factors occur and sales go down, but it's a market wide thing; then obviously management shouldn't be punished for it. Again, this is very industry specific, but there was a case, I think by Murray, where he disagreed because he said that for example back in the days in the oil market when all prices went up, and therefore companies' revenues increased and management got huge bonuses. But it wasn't the management causing the performance increase, it was the market. Therefore, it shouldn't be like that and if the reverse were to happen and oil prices were to slumber, then management will lose out and it shouldn't be the managements' fault.

Mr.B: Well, the way to do that usually is if you have performance metrics, is where the **performance of your peers is taken into account as well…**

FG: Ok.

Mr.B: So if you **benchmark it against peers.** Now the **hard thing is to find the appropriate peers.**

FG: Yes.

Mr.B: If the information is available. But that's how you could do it. So for example we work a lot with pork prices and all those things. So pork price is set by market demands and the likes, right?

FG: Yes

Mr.B: There are futures and all those things where you can see what the pork price does. But it **depends the market you are in and which sector you are in.** So it's not that if you go to the Chicago board and see what the future in pork does, that it's appropriate for a project in Romania.

FG: Yes.

Mr.B: Obviously it's not exactly like that. But what you could do then is say: **"Ok, well there's market demand and there's a gross margin" and if you manage to increase that then you've done better.**

FG: Yes.

Mr.B: If there is no peer-marking available, but you would firstly see if there are readily available peer benchmarks, and you would benchmark that again. But again that's as well part of the **budget**.

FG: Yes because in a budget you take into account…

Mr.B: I know a lot of banks, when they put **budgets** together they let the control guys do that and the way the controls guys do that is say: "Ok, well plus 5%, plus 10%". But that's the easy way. **So instead of just bottom-up you say: "Ok, what does the market demand do?" Then based on that what you expect it to do within 12 months and based on that you put your budget together and put performance metrics in place.**

FG: Ok. So is that something that is quite regularly done, to compare peers..? Well I guess you said it comes into the budget part, so not so much… well in a way?

Mr.B: It's "**subconscious**". It's not always done very consciously, but in a sub-conscious that's usually how you do that.

FG: You compare. Ok. So you're not saying: "right, your compensation is based on how your peers do", but it's based on a budget which in turn is based on how your peers do…

Mr.B: Yes, and **general market developments and all the things. You may set a ratchet in terms of how much you outperform the budget.**

FG: Yes.

Mr.B: But the thing with that again is that: **"Is there an incentive for management to have a very easy budget?"**

FG: Yes

Mr.B: And again, that's the conversation you have…

FG: And that's where trust comes in.

Mr.B: …and that's when **trust comes into play** and you say: "well you know, if market is growing by 5%, you can't have a budget that only assumes 3%". The question is: "why are we only going to grow 3%?"

So in that sense **budget rounds are, in setting as well incentives and performance metrics, are very important and not just a theoretical exercise** of +5 or +10%.

And that's where the **board comes into play, and is as well the reason why we always would like to be on the board.**

FG: OK.

Mr.B: Even if we are a minority investor. Because it's not as much only about the day-to-day operations and the quarterly review, but it's as well in this kind of **"budget approving setting procedures"** where that comes into play. **Especially if performance is part of the benefit package to management.** If that's not the case, then it is less of an issue.

FG: Perfect. I think that was super interesting. Thank you so much for your time.

Mr.B: You're welcome. Could you share your final dissertation with me please?

FG: Yes of course.

Mr.B: I would be interested to read it.

FG: Yes of course. In terms of confidentiality, would you like me to anonymise any of this?

Mr.B: No. I haven't said anything in here which is confidential. It's just the way we work I think.

FG: Ok, so is it ok if I use your name and JB Equity's name?

Mr.B: Yes. That's fine

Appendix A.6. Interview Transcript 3 – Calash (2)

Interviewer:	Francesco da Costa Gatta (FG)
Location:	University of Edinburgh Business School
Interview Subject:	Mr. Alan Evett (Mr.E)
Company:	Calash
Position:	Director
Offices:	Aberdeen, London, UK
	Sydney, Australia
Type:	Phone Interview
Duration:	16 minutes
Date:	Wednesday, 10th of August 2016

Mr.E: Hello

FG: Good afternoon Mr. Evett. This is Francesco from the University of Edinburgh. How are you?

Mr.E: Fine thanks. You?

FG: I'm fine thank you. Are you free to talk now?

Mr.E: Yes.

FG: Perfect. Thank you. So, just before I start I wanted to ask you if it's ok with you for me to record this conversation, so that I can then write a transcript for my dissertation.

Mr.E: Yes.

FG: If at any point you would like me to stop recording, then please just let me know and I'll pause the recording. Is that ok?

Mr.E: Yes, no problem. Shouldn't be the case.

FG: Perfect. Basically my dissertation looks at Management Incentive Packages, namely after a company is bought through a Leveraged Buyout, but not specifically for the questions I'm going to ask you. What I was trying to identify is what Incentive Packages are put into place nowadays in terms of bonuses, share mechanisms, basic pay, in order to motivate the management to ideally carry out a business plan that would normally take a longer time span than the vesting period set by the Private Equity firm, say 4-5 years… Therefore motivate them to achieve these goals.

Therefore the questions I would have for you are: I assume you have experience with M&As and LBOs, so I just wanted a little background on what your experience would be in these cases.

Mr.E: Yes, certainly. We've been involved in nearly 500, well over 500 M&A transactions.

FG: Yes

Mr.E: Working predominantly on behalf of the Private Equity chiefs who acquire these businesses. **Not all of those companies were we involved in the Incentivisation Packages associated with it.** But **I've actually sold my business twice before to a Private Equity, so I have fist-hand experiences myself.**

FG: Perfect. In terms of being on the acquisition side of the deal, I know that vesting period changes depending on sector, but is there what you would consider nowadays a "normal vesting period" for Private Equities or is it very case dependant.

Mr.E: It **depends very much on the house. Typically 3-5 years** is the standard sort of cycle, however **some have obviously longer holds**. But 3-5 is not unusual.

FG: Perfect. A lot of the companies I'm looking at are predominantly based in France and have a compensation mechanism called a "Ratchet Share Mechanism".

Mr.E: Yes

FG: Are you familiar with these? Is it something that is also quite common in the UK?

Mr.E: Yes. Very much so. It's a standard incentivasation. Basically, as you know how it works, but **if you exceed target or if you exceed PE,** the investors price… erm… **you get a ratchet based on the incremental increase in the valuation.**

FG: Perfect. Would you say it is normal for the management of these companies to also invest with the sponsor? So do you get a "buy-in" from the management? Or is it again case dependant, or is this quite normal practice again in order to try to align the interests?

Mr.E: In most cases the **Private Equity will not invest unless there is management alongside it.**

FG: Ok.

Mr.E: So therefore **it is usually a precondition of a Private Equity deal that the management is aligned. If the management doesn't want to be aligned or is not interested in being aligned, then 9 times out of 10 the Private Equity will not do the deal.**

FG: Ok, very interesting. Perfect. After acquisition, in your experience, is the management more closely monitored? If so, how? Is it through regular briefings and monitoring of the management or are milestones set in an annual/semi-annual basis? And what are the reward and/or punishments for meeting and not meeting these milestones if that is the case?

Mr.E: Yes. I think **it's the former rather than the latter**. In most cases… reviews take place… most Private Equity houses are fairly heft-up from the management perspective. So effectively they might **have 1 or 2 seats on the board, to provide direction and effectively they monitor the business from a financial perspective rather than any additional KPIs.** Key Performance Indicators…

FG: Yes

Mr.E: …That would be **driven chiefly only when the company is not performing**, **falls behind, in its forecasts.**

FG: Yes.

Mr.E: Then any forward remedial action takes place. And, depends on what is happening, but quite often it will be then **changes of management. Often at a leadership level rather than the complete management team being changed out.**

FG: So, you said at a leadership level rather than the complete management team being taken out?

Mr.E: Yes, I mean obviously **there are exceptions to the rule. But usually, you know, the CEO – the guy who front the company, who's in the board meetings – if the company is not performing, he's the guy who's responsible for it.**

FG: Ok. Also, again on the topic of management, is it normal for management to be brought in externally into the company after an acquisition? Or do you most of the time try to work with the pre-existing management? How is that basically decision taken?

Mr.E: It's **both**. It just **depends on the skill sets of the existing management team**. I mean, when we get involved in the **diligence operation** we **might look at the competence of the management team**

from… from what they are trying to do, we might look at it from a **psychometric perspective**. We might look at it from a **"Gap Analysis**" to determine: "what's your plan?" and then **additional personnel will augment the team accordingly.**

FG: Perfect. And when you go and look for external management, do you look at… I don't know… CEOs or management from other companies in this sector? Or where do you source this management from?

Mr.E: Sometimes. Uhm, it's a combination of that. We might do direct head-hunting ourselves or work with people who are specific head-hunters. Often you are **looking for somebody with a bit of experience, an alignment and an understanding of the business, so that you are not sort of educating management for 6 months before they actually make a contribution.**

FG: Perfect. Do you have any experience, you already mentioned that this is probably of the Due Diligence process, but looking at what the management compensation and there incentive packages are prior to the acquisition and possibly having to go in and "tweak" these or adjust these in order to change the motivation or alignment of the interests?

Mr.E: Yes, certainly I do. The majority of compensation packages don't necessarily change very much from a "monthly dollar take-home" perspective…

FG: Ok

Mr.E: Because that's not what the equity house is investing in; it's **investing in the future growth of the company**. So therefore what they'll do is **they'll incentivise management on exit. On valuation exit, not on valuation going forward.** They may say **that if you beat budget and get to a higher valuation throughout the journey of the investment, that there will be additional bonuses set up accordingly.**

FG: Ok.

Mr.E: A good example would be one business we've been in, where, **once you get above budget 25% of all incremental revenue is available to be split between the management of the company.**

FG: Yes.

Mr.E: Up to budget, there is no bonus.

FG: Which again is similar to what we described in the **ratchet mechanism**, where if you over-perform…

Mr.E: Same thing, yes.

FG: Same principal? Yes. Perfect. Would you say these percentages are case-specific? Or would you say there are industries you would expect to perform more maybe? I don't know if I'm explaining this correctly? Is it more case specific, where you set a target and then, if you exceed the target…

Mr.E: No.

FG: … by X amount? Or is it it…

Mr.E: No.

FG: Ok.

Mr.E: Not at all. It's very much based on the negotiating skill of the company. So you know… **If it's a stretched target to start with, so if it's a stretched budget, and you think it's going to be difficult to hit that budget you might as well ask for a large number and a large percentage above it.**

FG: Yes.

Mr.E: If you "**sandbag" the budget**, you might get a good bonus in year 1, but come year 2 the Private Equity know that you've "sand-bagged" it…

FG: Yes, absolutely

Mr.E: … and **they'll renegotiate.**

FG: Ok.

Mr.E: So **the whole idea is that you get a package, or a bonus package, which reflects the incremental value and the incremental growth of the equity investment**. It's not set as a multiple of salary or anything else like that, usually it's just based on… you know… whether you do well. That's how it works.

FG: Perfect. That is super helpful, thank you. Is there any particular cases of success or failures that you can recall, where a particular incentivisation package performed extremely well or didn't perform so well? Maybe because the interests weren't align or too much focus on the short-term, or something like that?

Mr.E: Uhm. Yes, I mean, I think **a good example of where these ratchet mechanisms do not work well is right now in the oil and gas sector.**

FG: Ok.

Mr.E: Where, **not due to fault of management**, the oil prices dropped and therefore the company just **cannot hit its forecast targets.**

FG: Yes.

Mr.E: The **company can do whatever it wants. It can reduce costs or whatever, but if you're relying on… You know, if you forecast it on oil at $70 a barrel and oil is selling at $30 a barrel, and you can't double your production… There is no way you are going to hit your revenue targets and your profitability.**

FG: Yes.

Mr.E: So therefore, **that sort of ratchet is actually a significant disincentive to management.**

FG: Yes.

Mr.E: So effectively what you have to do, or what equity has to do, in this scenario is **reset management requirements.**

FG: Yes.

Mr.E: So it may well be that they'll hold for an extra 2 years. But they **can't use the same incentive package**. Otherwise it's **totally disincentivising management**.

FG: Yes.

Mr.E: We are aware of a number of **places where management has actually left the company, purely because equity has refused to reset the benchmarks, or reset the incentive program**… So that these guys would be working for the next 5 years for nothing, with **no hope of getting any of their equity out or there investment back. So they've just decided to cut their losses and go somewhere else.**

FG: Perfect. That's very interesting and also what some of the other people I interviewed mentioned. They also said that sometimes the performance measure, instead of being absolute, they are sometime put in place compared to peers' performance. And therefore that's a way of avoiding… erm… If the market for oil prices is low, then the peers should be underperforming as well and therefore you can avoid the disincentive effect. Is that something that is quite commonly done, or how would you go about and do that?

Mr.E: N**o, I think that's aspirational rather than actually fact.**

FG: Ok

Mr.E: The reason is, although it is nice to say that, actually in reality if I'm an equity house and I've invested 100 million pounds in a business.

FG: Yes.

Mr.E: And just because the whole market is down, my equity is worth 110 million.

FG: Yes.

Mr.E: I'm **not going to actually incentivise management because it's worth 110 million, when my initial investment thesis was I'd be making 30% IRR.**

FG: Yes.

Mr.E: You know. So I think it's a **nice thing to say but in practice I don't think it actually happens.**

FG: Perfect. So you said it's basically up to the Private Equity, or the acquiring firm, to reset these incentive packages, obviously if they are based on unrealistic, unattainable targets. Is there a way to make them more flexible? Is it just: "ok, the target is too high. Therefore we will now make another package and lower it"? Or is there a way to make it flexible throughout its lifetime instead of always going back and readjusting it?

Mr.E: I think you have to **actually reset it**. You know, because effectively if oil price came back up tomorrow, you can't actually get that value back in 12 months or 12 weeks**. It takes a while for it to build.**

FG: Yes.

Mr.E: So what you have to have is an **open, honest relationship with the management team.** You know, when the management go into a deal they sit down and think: "well actually if I work on this business, you know, I'm to make 1 million 'quid'" or whatever number it happens to be. Yes?

FG: Yes.

Mr.E: So it's **up to a good equity house to actually, if management start to get stopped from doing everything to do that, it's up to the equity house to actually try to modify its incentive package so that the management team can still attain those sort of numbers that they actually invested on.**

FG: Perfect.

Mr.E: Ok?

FG: That's super yes. Thank you very much for your time.

Mr.E: No problem at all.

FG: Is it ok with you if I use your name and Calash's name in this interview? Or would you like me to anonymise it?

Mr.E: Yes, you can use it. No problem at all.

FG: Perfect

Mr.E: And if you'd like to send us a copy of your final output that would be great!

FG: Yes. I will. Once I'm done with my dissertation I will send you a copy. Perfect.

Mr.E: Ok. I look forward to that.

FG: Perfect.

Mr.E: Best of luck with that! Take care.

FG: Thank you very much. You too.

Mr.E: Bye bye.

FG: Bye.

Appendix A.7. Interview Transcript 4 – Scotto & Associés

Interviewer:	Francesco da Costa Gatta (FG)
Location:	University of Edinburgh Business School
Interview Subject:	Mr. Franck Vacher (Mr.V)
Company:	Scotto & Associés
Position:	Lawyer & Partner
Offices:	Paris, France
Type:	Phone Interview
Duration:	1 hour 40 minutes
Date:	Thursday, 11th of August 2016

Mr.V: Allô

FG: Hello, Mr. Vacher?

Mr.V: Yes.

FG: Good morning. This is Francesco from the University of Edinburgh. How are you?

Mr.V: Oui, I'm fine. You?

FG: I'm fine thank you. Are you free to talk now?

Mr.V: Yes.

FG: Perfect. Thank you. So, just before I start I wanted to ask you if it's ok with you for me to record this conversation, so that I can then write a transcript for my dissertation.

Mr.V: Yes.

FG: If at any point you would like me to stop recording, then please just let me know and I'll pause the recording. Is that ok?

Mr.V: No no. I'm ok. No issue there.

FG: Ok. So…

Mr.V: I looked through your paper, so we can address your issues and your questions.

FG: Perfect

Mr.V: Will just make it basic and straightforward. So question 1, the answer is no. No no no, usually when you negotiate a MIP, a management package…

FG: Yes

Mr.V: You cannot play on every field. i.e. either you try to maximise your return on exit or you try to maximise your pay as an employee during the course of the operation, of the transaction. But usually you cannot obtain two upsides. You have to choose. And even if the investment fund doesn't tell you that they are going to cut your package, even if you just demanded an increase employee package, well they just do it. So the more you get during the transaction the less you get on exit. So it's not the best strategy to demand and to request an increased package as an employee, because then you will lose it on exit.

FG: Perfect.

Mr.V: So usually what you have is… I would say a regular increase and what you have in principal is that you're going have an increase during the cost transaction, so you just negotiate like a 5%-10% increase in your wage. Same for your bonus, bonus scheme, whatever scheme and that's it.

FG: Ok.

Mr.V: So, ok?

FG: Ok.

Mr.V: I mean… It's just a matter of… You cannot claim everything.

FG: Ok.

Mr.V: Ok?

FG: Ok. That's perfect.

Mr.V: Then, second question. Hmm… sorry I lost your paper.

FG: That's ok, I have the questions here for you. The other question would be: "How do the MIPs compare with other non-leveraged buyout takeovers?" Are they…

Mr.V: Ermm… Just to justify this, what I understand from the question is you want to compare with, let's say, a public company. That's what you had in mind?

FG: Yes. I mean either public companies or… Yes, I mean or other takeovers that are not through LBO. But I mean… I guess most of them are so… Right?

Mr.V: Ok ok. Let's do some differentiation then. The main differentiation is between companies held and controlled by a PE investment fund whatever, a PE House and takeovers made by strategies – industrials and whatever.

FG: Yes.

Mr.V: This is completely different because to implement management package, what you have to understand is that what we negotiate is a portion of the return made by an investment fund. So… it may seem a bit silly but, what you need in first place is an investment. It's someone investing money as a basis for calculating a return and then claiming a portion, which may increase in light of performance and so and so and so. But you need someone, in the first place, who is investing money just to get a basis to calculate a return. And when you have a takeover with a strategist, industrial and whatever – not a PE house – then you don't have anyone investing money. Of course, you can say: "Well, a merger… we know how much we will invest to buy a company". Well no! This doesn't work. Because you have to invest in cash. It's usually something occurring on a basis of share-for-share exchange. It's totally different! So usually you don't have any package. And our clients, when they are in said process, are just very afraid and fear strategics because they know that they are going to lose everything. Because **no package will be implemented.**

FG: Ok.

Mr.V: They are just going to be taken-over and then, usually, fired… If they are not the best managers of the surviving entity, they will be fired. So they know that they are going to lose everything. And this is why what we like – well, because we are lawyers and we need appeal to our clients – but what we like is a "safe process", which is won-over by a PE House. Because then we are sure that we'll be in a position to roll-over a portion of the previous management into a new management package and thereby increase the portion that we'll get on the next exit. But when you have a strategic acquisition, then everything is over.

So, the main differentiation is split between PE house and strategic. Second one is also between private and public companies. You have in a way the same problem with a public company, because you are not in a position to easily compute a return… Because you have many shareholders who have invested on the basis of various prices, because you are stepping into the company at X or Y price depending on the listing – on the price – you never know. So it's not easy to compute a return, and this is why **when we implement packages in public companies it is totally different.** It is more something that is a long-term incentive plan that is something that replicates a sort of bonus based on performance milestones. And you just try to optimise it from a tax perspective, but not more than that. It's not something that will entitle management to get a portion of the capital gain made by an investor. Because in that case, as I said, you have many investors with many investment prices. So you never know, so you just do something else, and you do like a LTIP, or long-term incentive plan, based on preferred shares, pre-shares, stock options that will be triggered at an achievement of certain performance milestones. Totally different. Ok?

FG: Ok.

Mr.V: And usually… usually the return you can make on incentive plans implemented by public companies are… Well, nothing to do, does not come close to what you can do under PE house management plan. It's just totally different. Totally different… I mean, you can really get rich if everything goes well with a PE house. In a public company you have shareholders, it's public by a sense so everyone knows how the management is incentivised, and that's something that usually they don't like because you have newspapers, you have trade unions, you have better lots of… So you have differences there. Ok?

FG: Perfect. Just a question. You mentioned that you try to make the packages as tax-efficient as possible. How do you do this?

Mr.V: Well, hmm… It's always a tricky issue tax and especially in France. How do we do this? Hmm… Well, it's based on our experience and the mediation we have with the French tax authorities. You have sort of an evolution – a historical evolution… You know that management packages in France a pretty young in a way. Everything started back like 15 years ago I would say, at the beginning of 2000/2001. Not older than that.

In the beginning we had, it's one of your questions, we had what we call **ratchet tools.** So instruments, which are optional instruments, which will **entitle you to get a portion of the capital gain on exit. But a portion that has nothing to do with your initial investment.** And those instruments were heavily, heavily challenged by French tax authorities, because the usual weakness of those instruments were – as French tax authorities said – their valuation upon investment. i.e. of course we called experts and we had experts to value the instruments, but the claim of the French authorities were always the same: "No. You just undervalued that instrument"… And that might be true, but you never know because you are investing – you put your money at risk – you're investing in something. It might go well, it might go bad, you never know. And in certain instances… For instance… Let me think… It was a spin-off of GE… **Converteam! Converteam! The guys just made like 5000 times – 5000 times! – their investment. The package was worth 1 billion euros in the end and they invested something like 1 million euros.** So you can imagine that the tax authorities were like: "Heee! Erm… Is there not something bad with you initial valuation?" And the answer might be yes, might be no. I don't know because you know, when you invest you never know.

But this is something a ratchet instrument where… well… has this weakness. You just cannot compete, in fact you cannot fight and rule out someone for telling you: "well you made 1000-2000 times your investment. Well it means that definitely you just undervalued the option."

What can I say to do that? Yes, maybe, maybe not. There is no definitive. And we have shifted from those ratchet instruments to what we call **"Sweet Equity"**. Sweet Equity is something very, very different and at this stage… At this moment – I cannot tell you that in 5-10 years we won't have any issue with the tax authorities – but **at this stage, it's the best, best instrument to structure a management package in France.** I will mention the free shares, the "Macron free shares" later, but forget, forget about the "Macron free shares". It's very difficult.

FG: What did you call them? "Market free shares" did you say?

Mr.V: Macron, Macron. You know our Finance Minister: Emmanuel Macron.

FG: Ok

Mr.V: And what we call them: "Macron free shares". We can come back to that later but, forget about it.

We have "Sweet Equity". What is "Sweet Equity"? You know what we call Sweet Equity or not?

FG: No. Sweet? Equity.

Mr.V: Sweet. Like sweets...

FG: Ok. No, I am not familiar with it.

Mr.V: Ok. Sweet Equity is basically, it's not a security, it's not a share, it's a structure of capital. And what we do there to achieve a Sweet Equity mechanism is basically that we… **We request that the investment fund invest a large portion of their cash in a fixed instrument – a fixed-rate instrument. Whilst the management invest a larger portion of their cash into shares – ordinary shares.** And the idea there is that when you invest 100 and out of these 100 you invest like 70 into fixed-rate instruments, 70% of your investment will be capped at some point in time. It will be capped at the rate of those fixed-rate instruments. And if you perform well, this means that your return will be in any event, on those 70%, limited to your rate. Let's say… 11% to 12%.

So this will be a nice return – 11-12% – but nothing compared to the 20-25% you might make on the ordinary share, where you don't have any cap. By construction, you don't have any cap on ordinary share. So, if in the opposite, the management is investing 80%, 90% of his 100 into ordinary share, then assume that you perform more or better than the fixed rate – let's say 11 or 12% – then you capture everything, all the value creation with your ordinary share. And of course, what is interesting here is that the portion of the management in ordinary share, will be dramatically increased compared to the overall investment amount invested by the management, and the investment fund.

Let's say I wanted to negotiate a Sweet Equity mechanism. I request the PE house to have like, let's say, 5 million or 8 million in ordinary shares, and I invest 2 million in ordinary share. But my… My… I am from the management. My investment, my overall investment will be like 3 million. Whilst, the overall investment of the PE will be like… I don't know… 208 million euros. And you see that my return, in terms of a multiple or performance, will be – if I perform well of course, if I perform well – if I perform well, my return as management will be dramatically increased and will be disproportionate to my initially investment. Because I will capture, like 20% of the ordinary share return, while I will have invested like – well you do the maths better than I do – but 3 million compared to 208 million of the PE. So you see, my portion of the gain will be just better than my overall investment.

And this structure is, at the stage – at the moment we are talking – this structure is, well… "bullet-proof" I don't know. But we have no litigation on that structure. So…

Hmm… "Macron share". "Macron share"/"Free share", is a new instrument. It's something very, very specific to France, I'm not sure it's very relevant for you, but this is something we have been using for like 10 months. Because it was implemented last September. Hmm… What we do with "Macron share" is something very interesting. We are recreating "ratchet instruments" but pre-instruments. Haha. Which is… like at this stage we don't believe that the tax authorities have freedom to choose what is going on here. Because usually, as I mentioned to you, the weakness – the main weakness of the ratchet instruments were their valuations. They were always challenged. And now, what we are doing is a sort of "Free ratchet". So, we don't even go into this debate of the valuation. We just say it's free, it's a new regime. We are allowed to issue and allowed free shares to management and employees. So we just do that, there is always – of course there is a limit: 10% of the share capital, but within that limit we are free to do what we want. And what we are doing now is just replicating the old ratchet mechanism. So you get a portion of the capital gain, upon exit, based on the performance of the transaction. And… in a sense it's a ratchet instrument, because you have like let's say 8% of the share capital with your free shares, but you can get up to… well we limit it to 10% of the value of the shares just to avoid any, any tax issues with the tax authorities. But in a sense I may only 1% have of the share capital with free shares, and get up to 10%, but based on performance milestones.

i.e. to get the 10% - the maximum 10% - the transaction will have to perform well. But you see, it's exactly what we call ratchet. **Ratchet is just a "relution"** [accretion]**, you just get an increased share of capital gains, based on performance milestones, which has nothing to do with your initial investment.**

As I mentioned **Converteam: 1 Million Euros – 1 Billion Euros upon exit.**

FG: Ok. What's the name of the company sorry? Conv… Converteam"

Mr.V: "Converteam". Like "convert" and "team". It was a GE spin-off. Probably the best package ever in Paris. Huh! It was not capped, this is why. It was a drafting mistake by the other side lawyer… And believe me, haha, they are not screwing-up again. Haha

So it was like, once in a lifetime, but we did it. And the guys just ran to Belgium. Anyway, is that clear?

FG: Yes. So to reiterate... Basically the ratchet allows a proportion of the capital gains if you meet or exceed a target, but it's not proportional to your initial investment, is what you're saying? So its completely irrelevant of your buy-in.

Mr.V: Absolutely! Exaclty. While **"Sweet Equity" is not based on performance milestones.** Of course our rule-of-thumb… **Our rule-of-thumb is that if your performance measure, IRR or money multiple whatever, your measures are better than the fixed rates, then you will get a good portion of the package. But, but, but… If you perform bad, i.e. if your IRR is below the fixed rate, then you lose all of your investment.** Because, what you have to understand is that you have a preference… Hmm, usually we structure it with either creditor rights, let's say converts of these bonds or preference shares, preferred shares, whatever… Which are private, which have a private rank to ordinary shares. Meaning that if you are not performing well, i.e. your performance is not sufficient to serve the fixed rate, then you lose all of your investment, or almost all of your investment. Because, as I mentioned, you usually like 80 up to 90% of your investment into ordinary shares and the rest is invested, the balance is invested, into fixed rate instruments by the management. So you have like 10% of your investment which is not at risk in a way. Well… it's at risk, but you share the same level of risk than that of the PE house.

FG: Yes. And what are these "fixed rate securities"? Is it bonds? Or…?

Mr.V: Yes, bonds, converts – or convertible bonds, shareholder loans… Hmm, "alphabet shares" if you are in Luxembourg. All of that kind of – oh, and preferred shares as well – all of that kind of instruments which entitle you to get a fixed return. So bonds are the best example, but you have better than that. In Luxembourg… **You know Luxembourg is very flexible on those instruments... They may be creditor instruments in Luxembourg while they are equity instruments in the US. The qualification is very subtle in Luxembourg, you can do whatever, bah… in a sense you can do whatever you want in Luxembourg.**

But what you have to understand is we differentiate fixed rate instruments and ordinary shares. And **ordinary shares are extremely important, because tax authorities cannot fight against ordinary shares. It's very difficult for them to challenge that kind of structure because, what can they say?** You are – me, you, I – we are all free to structure our investment in a way that is… well that fits, I don't know, our needs, expectations and whatever. We are free – well at this stage and so far – we have been to structure it as we see fit. **So it's very difficult for them to claim that there is, like an advantage that has been granted to or awarded to the management, or to say that it's a sort of disguised employment benefit. Because it is not. It's just something we have structured in a way that we believe it to be efficient. And it is very difficult for them to challenge it.**

Of course, the usual rational in Paris, amongst lawyers and PE funds, is to say that we cannot stretch the "sweet structure" up to a point which is very, I would say, well it's obvious… But I say 90%, it's very obvious that, well the fund is just structuring it in a way that will enable you to capture a greater return compared to your overall investment.

Again, it's a matter of proportion, it's not a matter of… It's not a "relution", it's just that you a disproportion – an insured disproportion – between the investment of the investment fund and the investment of the management.

FG: I understand what you are saying, but visualising it would also help of course.

Mr.V: Yes, no no no, I can imagine because it's a bit theoretical. And it's very difficult to, well… To graph it, unless you see an Excel sheet because, well again it's theoretical… But in an Excel sheet you will understand it right away, **because you will see this sort of over-allotment in ordinary shares, compared to ordinary shares acquired by the PE house.** And you will see how it works very easily, because it's **purely mathematical**.

But sweet equity is, I would say right now, 90% of the management packages used in Paris.

FG: 90%? Perfect.

Mr.V: Yes. At least. Well… Well…. Just a reservation there… What you have also are **old investment funds – when I'm saying old I mean 20-25 years – who have developed their own structure, which they believe is efficient and well… It's not.** So you have alternatives in terms of structuring. What I can tell you is that **the only "bullet-proof" structure that we have in Paris is the "Sweet Equity". So I would say 85% in sweet equity. 10%, because of Scotto and the law from Scotto, with "Macron free shares" and 5% for this "old structuring", because you are structuring based on non-conversion of convertible bonds.** It's always the same, now that you have understand or at least you are more familiar with the sweet equity structure, you can imagine that if you have a certain amount of convertible bonds that will be converted, or not, based on the achievement of performance milestones, you can now understand that a greater portion will be allocated to the ordinary shares held by the management… If, for instance, you don't convert a lot of convertible bonds. Because then, for the exact same reason as those for the sweet equity, the non-conversion will cap the return on the convertible bonds to their rate. While if you convert your convertible bonds, you will capture the return of the ordinary shares. You see what I mean? And you will dilute the management. So you have this sort of mechanism based on conversion and non-conversion, but those mechanisms are heavily challenged by the French tax authorities again. Because it it's very difficult to explain to the French authorities that, upon exit, you will convert more or less of your convertible bonds, without giving the idea or conveying the feeling that you are granting or rewarding something to the management. And that kind of rewards are re-qualified as employment benefits, and then you lose all the taxation upside that you have been trying to achieve with your package. Because if you are enclosed on the basis of employment taxation, then you lose a lot. **You lose a lot.**

In France for instance, it's more than double taxation. It's 2 times taxation compared to capital gain taxation. And I believe it's the same in the UK… It's even more in the UK, because in the UK you have this “entrepreneur relief mechanism” which is probably the best we have now in Europe. I think… The UK is more like 5% taxation on capital gain when you have this “entrepreneur” relief, compared to 38% in France. So you see capital gains… Uhmm, wages are imposed at… 64% the highest rate, 64% in France. So you see from 38 to 64. You have… well it’s not 2 times it’s 1 and something times. But you have a huge, huge incentive to structure it, first as capital gain and second to have something that is “bullet-proof”. Ok?

FG: Yes. That is very helpful. Thank you very much.

Mr.V: No, you’re welcome. Uhmm… I don’t know whether or not question 3 has been answered from your perspective.

FG: Yes. Yes… There is still…

Mr.V: Common practice. Uhmm, no it’s not a common practice. For instance Germany… Germany, Spain, Italy, are very reluctant to implement ratchet structures. Ratchet instruments were heavily used in France, as I said like, up to… Up to François Hollande. You know François Hollande, so 2012. Haha. Up to that moment in time it was heavily used and then totally disregarded.

Hmmm. **In Germany for instance, where you’re going to have kind of the same practice I would say, it’s not as natural as in France and the UK… There is no debate! You have to implement a management package with a sweet equity mechanism. Because a ratchet instrument doesn’t even work... Well, even if you value correctly your option – well… and as we mentioned many times it is always something that can be challenged – even if you have an expert report etc. etc. it doesn’t change a thing. Ratchet doesn’t work! That’s it. So in Germany for instance, my understanding is that, you can only implement sweet equity structure.**

FG: Perfect. That’s good to have a comparison of other countries as well. Just another question… On the… this might be a weird question, but on the topic of “Ratchet Share Mechanism”, I discussed it with other managers and directors in companies and it wasn’t always clear for everyone what this was or what this represented. When management work with this, are they fully clear on how it works, or does some of the management not really understand? Or there is…

Haha. Well my answer will be quite straightforward. My managers, well the managers we advise, well we have at least the belief that they understand. Because what we usually do is a presentation, a big meeting, where we explain to them that… Well we explain to them that to get rich, to get “the big bucks”, they have a very, very, very nice pension seat to invest into their company, has be selected to invest and so on and so on… So there is always – as far as Scotto is concerned, because it's a matter of liability for us – a presentation, legal and finance and… well, finance presentation… At least we explain to them, always bearing in mind their business plan, where they might land and what might be their return in case everything goes well etc. And we explain the ratchet mechanism. Yes.

But, I think we are not so many lawyers to understand both finance and legal issues. And I'm not sure that you have a presentation made by independent lawyers in every transaction. Well, when I say I'm not sure, I'm pretty sure it's not the case. And we have, for instance, we have colleagues at other firms who have been just sued by their client managers, because of lack of explaining and then the managers were claiming they weren't fully informed and so and so… And they were challenging their investment decision.

So… In the underline, no I don't think that every manager is fully aware of what they are doing. Especially that a ratchet mechanism is something that is at risk, where you might lose everything! **Because usually what we do with a ratchet – as I mentioned it's always the same, let's go back to that – we value an option. So you are buying an option, it's like a call and put. Just the same as on the finance market. So you are just buying an option. And, well, this price might be lost. If you don't perform well, you might just lose everything. And we have seen – we will explain it as it's one of your questions later on but – we have seen situations where management just lost everything!**

Because the way a ratchet… a ratchet. What is a ratchet in a sense? A ratchet is just a "relution" of your portion of the share capital. Let's say you have 2-3% of the share capital, whatever the instruments. It's usually preferred shares, or it might be also warrant, warrant structure, which enables you to acquire or subscribe for additional ordinary shares, but it's exactly the same. At some point… at the beginning of the transaction you have 1%, 2% of the share capital. In the end, you are entitled to sharing rights, I don't know, 10-12% of the overall capital gain. If, if you had stuck with your, not ratchet but your portion of the share capital, you would be stuck with your 1-2%. And then in the end you would only have 1-2% of the capital gain. A ratchet enables you to get much more than your initial share capital portion. So it's a "relution". And you can achieve it with preferred shares, which I prefer because you don't have an issue... Because warrants is very complicated, because warrants you have to put some actual money to acquire the ordinary shares. You know, upon exit. And it's always a pain in the neck because you have a lot of logistics there, you have to… Usually managers don't have any cash at hand. So you have to find a way to finance the acquisition of the ordinary shares. Of the number of ordinary shares which you are entitled to, based on the number of warrants you are entitled to exercise, based on the performance milestones. And it might be very painful. Might be very painful to organise this process. So we prefer preferred shares, but again sometimes you advise clients who have been managers in a transaction – a very old transaction for, let's say 7-8 years – with a structure that was implemented like 8-12 years ago. During those times warrants were efficient, so you have to unbundle a structure with warrants. And you have to do it. But now, going forward, we try to avoid this.

But ratchet is just that. It's just you have 1%, you get 10%. You have 2%, you get, I don't know, 10-12%. And the more you perform, the more your share will increase. Then **you have technicalities, we can just mention a few. What is then the return you share in? The return might be the overall return, so the return of all the shareholders; the return of the investment fund only. This might be a marginal return only, so let's say you have a threshold of, I don't know, you get 20% above 15% of performance [IRR].** It might be a lot of things, but in a sense what you have to understand is that you just **get an increased portion of the share capital compared to you initial position**. Ok?

FG: Yes. I think that that answers that very well. Moving on to the next question… Question 4: Is there a standing vesting period?

Mr.V: Yes. Ermm… Vesting schedule… Yes, so in France – something different than compared to the UK for instance – because usually we differentiate the UK and continental Europe, where practices are somewhat different. But in France you have 3 categories of leaver: good, medium and bad leaver. The vesting schedule is usually 4 years for good leaver, 5 years for a medium leaver and bad leaver you never vest anything. And the trend is an increase because the **glorious days of management packages have passed, unfortunately. Well, I would say the "golden age" of LBOs also. Whereas 10 years ago we were in a much stronger position to negotiate better vesting schedule.** But you have to also bear in mind that vesting is something, something very tricky in a way.

What is vesting? Vesting is how you deal with someone who is leaving before a collective exit. So an IPO or sale or whatever. You have to strike balance, find the right balance, between who leave and those who are staying in the company. And if your vesting is too generous with those who are leaving, then you might end up with something that is – it's a bit counterintuitive – but you might end up with something that is a deductive… that will wreak havoc on your management, on you current management. Why? Just because they will now think that they are working for someone who has left the company. Let's say you may vest 100% of your investment… Just by the way, what we call vest is that you get the full value of your investment upon exit. There is no discrimination. So imagine you leave after 3 years, as a medium leaver. In France, medium leaver will be… Umm, I don't know... You are being dismissed for bad performance. You are being let go because, well, we don't want to keep you. But you haven't committed a wrongful termination, you just leave after 3 years and the exit occurs 3 years after, so in year 6. What will happen is that you have the full value of your investment upon exit. So 3 years after, why have you only stayed 3 years in the transaction and you get everything? Well, it may sound a bit harsh, but those who are making the exit, who are staying up until the 6th year, there is a feeling of loyalty but also a feeling of… sense that you have to achieve here, that you have to take into account. And usually… well usually… I would say quite often, our managers say: "No, no, no. You are being too generous! Someone who is leaving, someone who resigns or… I don't care! That guy doesn't get the full value". And we also have managers who just say even if you are a medium leaver, even if you are a good leaver, you will never get 100% of the value you would have gotten had you made the exit. There will be like a 20% discount, 10% discount, but you will never vest 100% of your investment, because they **want to keep everyone who is staying, motivated.** So this thing is not something that is imposed by the PE house, it's something that is very dependent on the conception of the management and what they want. It's very funny because of course we have our templates, our basics, at Scotto we tend to be generous and protective, but sometimes **we are just being challenged not by the PE house but by our clients! They say: "Hey guys, huh, you are doing too much for someone who's left!"** You see… It's a matter of balance really. In the first place it's a matter for the management, not for… it's not an issue… well it is an issue between the PE house and the management, but in the first place it is more something that is to be discussed and designed by the management itself. The CEO, the CFO... It's something very important to understand, I think.

But the trend, as I mentioned, is increasing. Old, old scales were 3 years in good leaver, 4 years in medium leaver… Now the standard period is 4 years and 5 years.

FG: Ok, perfect. So increasing trend? Perfect.

Mr.V: Yes.

FG: So, that's that question done. Perfect. Now going to the management – I don't know if this is particularly your area – but how do you choose whether or not to put in new management?

Mr.V: No, usually it depends… It depends a lot. But usually incumbent management stays. You don't dismiss them. It might happen, but it's not usually the case.

FG: Sorry, you said "incompetent management stays"?!

Mr.V: No. "Incumbent".

FG: Oh, "incumbent"! Ok ok, sorry.

Mr.V: Managers in place just stay in place, is usually the rule. And why is that? I think it's not something… Uhm, how does it happen? Well, we at Scotto, **when we feel during the negotiation that there might be the intention by the PE to change the management, then what we tend to negotiate is an increase "golden parachute"** for the 2 first years. For instance 24 months, just to make sure that they are not going to dismiss them. That it's not their intent. But it's not usually the case because the one who is selling the company, you know, making the investment funds invest, is usually the management. **It's very difficult for a PE fund to invest in a company with no management.** It might happen, again, especially if you are in the restraint pattern. But **it's not usual. This is not usual.** Or you might have… If you are bank capital, you might have like 10 of… manager… transitioning manager and so… But it's not usually the case. The PE fund just invest and rely on the management to manage.

But they might request, and I have seen that many times, they might request a change and say: "Well, you're CFO is a bad guy… He's not the right calibre". You know, when you've been through many rounds of LBOs, well you're size has been increasing as well. You might end up with a big company with the same management as the one that made the first round. And you might have sometimes discrepancies, where the CFO just doesn't know how to manage… I don't know, bonds, complicated financing structure, all this kind of debt and so on. You might find someone who… I don't know… Well, for example someone who doesn't speak English for instance. In France this might happen. You have many cases, but yes… This happens but again, it's not the usual… not a huge trend.

FG: Ok. Perfect. Next question…

Mr.V: Ok, specific mixes… You are referring to structure of… What do you mean?

FG: Yes.

Mr.V: Ok, the answer is no. The answer is basically no, haha. No, because it otherwise has the same mechanics. Someone is putting in money and you just negotiate a portion of the return that he is making on his cash, that's it. So there is nothing to do with sector and so and so.

That being said, what we tend to do is negotiate… You know, **what is really important when you are in a company whose intent is to make a lot of acquisitions, bolt-on acquisition and so on… The idea is to negotiate a protection against dilution.** And there, yes! You may have differences between, not sectors, but between companies with a lot of acquisitions expected in the business plan, compared to organic growth. But apart from that, I don't see differences.

FG: And what are these anti-dilution mechanisms you would use?

Mr.V: Well it depends. **If you are with the ratchet structure it's very easy. You are going to request that you get the same portion of capital on the new equity as that on the old equity. And of course the PE house will tell you: "Haha, no, no. If the cake gets bigger, it doesn't mean that you get a bigger piece of it."** And they try – and this is why understanding a ratchet mechanism, by the way, is very important – and they try to trick you because, haha, this is right but… **If the pie gets bigger, of course you will get a bigger amount. In absolute terms, you get a bigger amount. But just because your pie gets bigger, that doesn't mean that your percentage increases… You're percentage decreases, by the way… And they try to trick you on that.** This is why it's very important to have… If you don't understand it, the best advice is just to go to a good lawyer firm or whatever.

But anyways, ratchet is very easy and what we end up with is sometimes, something like, **we get the same percentage on 50-100 million which are invested**, after closing. And if **an additional 100 million euros are being invested**, on that new 100 million we don't get anything. It's not that we don't anything, but **we don't get an increased percentage**. You see what I mean? So, you just say: "Ok, we can accept on the…" It depends, and it's very **important then to discuss with your management and to understand the amount of acquisition that is expected and how they intend to finance it.** Because you can of course finance it with your cash, with your debt or with your equity. And what we want to **avoid here is to finance it with your equity, of course, because this is when you get diluted.** And it depends, it depends a lot, but if **for instance your business plan foresees like… I don't know… 60 million of acquisitions**, then what you are going to do is **negotiate the first 60 million euros in equity that are being reinvested by the investment fund after closing, and over those additional 60 million then you don't have any protection.** It depends a lot, but you see, you see how you can protect your ratchet.

When it comes to sweet equity it's a bit more complicated… Haha… **At Scotto we call it the "Holy Trinity".** If you want to be well protected, you have 3 provisions which are very important:

The first one is that you have to **force the investment fund to invest at fair-value. i.e. never at closing value.** It's very important. Because if you have an increase in value, **let's say you go from 1 to 10, if a guy who invests at a later round at 1, while the value is at 10, then you get a massive dilution!** So the **first requirement is to invest at fair-value. At the then fair-value! At the value which is**

considered to be the real value upon investment, not upon closing. Because value upon closing is something… and we all hope there is an increase in value 2 or 3 years after closing, so you cannot claim that you're going to invest at the same value. But sometimes it happens, so you have to be very careful.

The second is to make sure that you have, what we call in French "pre-emption rights". "Pre-emption rights" is not the correct term… It's just **preferential right to subscribe for additional shares. It depends, in various countries it depends, it might be statutory, it might be contractual.** But you have to make sure that **you'll be in a position to exercise your preferential rights on the newly issued shares.** You see what I mean? Very important

FG: I understand yes. I think is some places this is statutory, but you are saying in France it is not, so you have to put it in a contract?

Mr.V: It is, but **what might happen is that the majority investors – so the investment fund, who is also controlling the company – might just disregard this mechanism. It's just majority rule so… Not majority 50%, it's 75%.** So here it's very easy to say: "haha guys, I just vote – because I'm the one who is control, who is in charge – I just vote that this issue of shares will not be made with preferential rights. And that's very easy. So it's very important to make sure that you have this right… Even if you don't exercise it, because it's usually the case, you don't exercise it. But at least you have it. And it's very different you know, **sometimes we have clients who have cash – who have kept cash – for further injection of cash.** So the situations may be very different.

And the **third requirement is that you invest the new equity in the exact same proportion, between ordinary shares and fixed-rate instruments, as the proportion at employment.** For instance if you have… And, and **by investor, of course.** So if the investment fund has invested 30% in ordinary shares and 70% in fixed-rate instruments, then it **is extremely important that the new 100 be invested in the exact same proportion between categories of securities.** You can do the math, you will see.

With these 3 requirements, if new cash is being invested by the investment fund, and the management cannot follow, then you just **mitigate and alleviate a lot the dilution.** While, of course you can imagine that if… haha… **if in the opposite, the investment fund had the right to invest 100 in ordinary shares only, then your sweet equity would be just ruined. You would be just so diluted**, that it would be… you would, I don't know, you would just run away because **your package would not be worth anything.** Ok?

And then you have, of course as you can imagine, you have a lot of discussion, specificities, alternatives and so, but the basics are there.

FG: Yes. What were some of the other things you just mentioned, sorry?

Mr.V: Well, you have a lot of alternatives… You can limit 1 of 3 requirement, as I mentioned to you, in certain senses. For instance, this person will tell you: "Ok, I am **willing and happy to have these requirements, but only on the first 100 million". Just exactly in the same way as the ratchet mechanism. It's just a matter of negotiation, there is no fixed rule.**

But **a good package – a correctly negotiated package – will include those provisions.**

FG: Ok. Perfect. Moving on to the next question… You already kind of touched this, the differences between management incentive packages in…

Mr.V: Yes. No, no, the idea… Yes, there is a huge different between, I would say, UK and US base package and continental Europe, and especially France. **France always stands for the most aggressive and the most protective country for management.** But I guess it is not a surprise for you. But **apart from that, yes, you have a big difference. UK and the US tend to implement a package with a nominal investment. i.e. a very limited amount required from the management, or no investment. It's a "free package". It's very common in the US and also in the UK.** And the flipside of that is that they don't want to negotiate, it's just free, **take it as it is or just leave.**

It's very difficult for us to negotiate a package with a UK-based PE, because it's difficult for them to understand our tax issues – because they have specific relief for investment packages, like entrepreneur relief – and for us it's very difficult to explain to them that we had issues… That we **need to invest a fair amount of cash, because otherwise this will be seen as an award of benefits, employee benefits, and – as we mentioned in the beginning – this is something that is heavily imposed compared to capital gain taxation.** So we have a very, very important requirement here: To invest an amount. Whilst the **UK and the US, they don't care about it**. So, they just say: "Guy, regarding vesting, well in a sense we can fire you". **Usually you have only 2 categories of vesting: "good" and "bad leaver"**. Very straight forward. Bad leaver is like a book, while good leaver is only a few lines. It's you die, or you suffer from an illness that prevents you from working. I mean, it's very limited. While bad leaver, is virtually all of the rest. **So as you can imagine it isn't very protective. But again, with this logic, it's almost free… You don't care, because your return will be – in any event, if everything goes well – will be very, very, very interesting. And because it's free, please don't request**

any protection against dilution, please don't request any protection regarding the exit… For instance the "tag[11] or drag-along[12]". You see what I mean? **Just don't claim anything.** It's free, it's nice, it's an opportunity for you. If you perform well, everything will go well. If you perform bad, then we will fire you, yes of course. The game, I would say, is the way it is.

And **to be honest, to be honest… I don't know what is the best system.** Because I have seen, for instance on this "Brake-Sysco"[13] deal. Brake is a UK based company, in the food industry… I don't know whether you know it… It was taken over by Sysco, a US based form.

FG: Sysco?

Mr.V: Yes, Sysco. The package was… Well, **it was incredible! The guy just invested a very, very small amount.** Not say nominal amount, like **1000-2000 pounds and just got a huge return, like 200 thousand pounds. It was incredible!** So my, my belief here is that I don't know… It might be good, it might be bad. The other thing that we have in France, we have developed an industry – a package industry – especially at Scotto, we have developed it, we live from it… And well, I cannot say it's better. It's just that it's different. It seems to me that both systems work well.

Just a remark here… It's more a trend, it's more a pattern that I have noticed. **I don't pretend to have the same experience with UK and US based companies. Just saying that what I've seen is all these kind of free, free instruments, or cheap instruments, enabling you to make huge returns.**

So, by the way, this is a pure ratchet mechanism.

FG: In the UK?

Mr.V: Yes. Yes in the UK, exactly. For instance if you take the Brake deal, well I think you could pull the *article of association* from "Companies House", and you will **notice that you have various categories of shares which entitle you to get – well based on performance of course – but enable you to get an increased portion of the capital gain.** The **more you perform, the better you perform, the more you get. This is achieved by a structure with various categories of shares: X, Y, Z…** Or might be more… B also. And this enables you… They were acquired at I think 1 cent, 1 cent each, and the value of the

[11] Tag-alongs effectively oblige the majority shareholder to include the holdings of the minority holder in the negotiations in order to facilitate the possibility that a tag-along right is exercised. (Investopedia, 2003a)

[12] A drag-along right is a right that enables a majority shareholder to force a minority shareholder to join in the sale of a company. (Investopedia, 2003b)

[13] (Massoudi and Cotterill, 2016)

shares upon exit of course, it was insane. But you see what I mean, it's just **a category of shares that is very cheap and enables you to make huge returns if everything goes well… Or very well…**

FG: Perfect. Ok, that answers that very well. Perfect… Let me rephrase the next question: "How may the ambiguity of this ratchet mechanism, influence the performance of management. Either for good or for bad?"

Mr.V: I think you skipped 8) no? You don't want to…

FG: I mean… Well, we talk about it. You already said that obviously firing someone would be a "stick" punishment. You said in the UK if you don't meet the target for example… But yes, if you have…

Mr.V: No, in France well… Normally you don't have a "stick" as such. Of course, if you are a "bad performer" you will be let go. Then, you always have this **mechanism of call option**. And what is important is **at what price your share, your investment, will be repurchased**. And sometimes, yes, you do **have a discount on your initial value, on your initial investment. For instance you get 90%, you don't get 100%, but you get 90%. Especially if you are a bad leaver. If you are a bad leaver, we have seen situations where a PE says: "Ok, you are a bad leaver. This means that you are sitting money in the company and you believe that I will repurchase – I will redeem you – at 100% of you initial investment. No, come on guy! No way. You must be kidding…"** And sometimes this happens… But usually if you are a bad leaver, you just get your value with no upside.

FG: Ok.

Mr.V: So 9) then… The best motivator… It's very difficult because it's more something for a MBA guy rather than from a lawyer… But what **I have seen is that packages are extremely efficient at keeping people.** It's just creates, not I would say loyalty, but… Well for instance, I have a client – I'm sorry I cannot mention him to you – but **I have a client, it's a huge company in France… Think it's the 4th LBO, so it's starting to be quite big. The managing director, the general manager, is just a pain in the neck. He is awful, everyone hates him… It's very difficult you know, it's like old management, old fashioned… You were referring to "stick", he has a lot of "stick" and he just beats everyone. Ok… But, but! He has a very good package.**

FG: A very good package did you say?

Mr.V: Yes. **The package for his management is just extremely good!** And it's people with no, or almost no, degrees and so… have the possibility to make a huge return. A huge return… **Imagine you have**

been staying at the company for 15 years. You will have invested like, I don't know, 20 thousand euros… Not a big amount, something that you can do because you have bonus to do that, and now those 20 thousand are worth 2 million euros… Well, believe me, you stay in the company and **you just endure everything that the guy puts in your face, because you want to get the 2 million.** You see what I mean?

FG: Yes, yes of course. And if you leave you don't get the 2 million…

Mr.V: Yes! You have perfectly understood! So, this is extremely efficient at motivating, at least keeping people in the company… Motivating for sure because… But **it's true for the top management**. But anyways, packages are usually for top management… Well it depends on structure…

We **have seen also something that is, I think, very inefficient: the trend to expand the size of the package, just to increase it.** An efficient package is something that is quite limited, limited to – depending on the size of the company – but limited to let's say **15-50 managers**.

FG: 15 to 50?

Mr.V: 50 yes. I think yes is most efficient. Because what you want to avoid here is something that is so diluted, amongst 200, 2000 managers, that your share isn't worth it.

FG: Yes, so small it's not worth it. Ok.

Mr.V: You see what I mean? So, so **motivation yes for sure**, because when you offer something to someone it's usually efficient, but you have to **bear in mind it's not efficient with every type of manager.**

Also, another example, we have a restaurant – so food industry – where the managers says, or the CEO is like: "Ok, I want to incentivise all of the restaurant managers." But can you imagine that a restaurant manager just understand something like this? No, doesn't understand anything. **What he wants is more a great bonus than a package. Even if he can make a lot more with the package, he will prefer a bonus. For various reasons, but at least for 2:**

The first is that he can just cash in the money and he just prefers that rather than an expectation of a return. Because he just understands… He understands it. You just cash in your money.

And second because he doesn't want to be stuck – it's just what I mentioned: loyalty – he doesn't want to be stuck in the company for years. He wants to be free to go somewhere else.

FG: Perfect.

Mr.V: So I would say yes. Motivation, but I think it's more interesting if you mention loyalty and your ability to keep people… Retainment! It's a good retainer.

So now… let me get my phone… 10)

FG: Yes. Do you ever find that management underperforms for unexpected reasons? Even when quite a generous incentive package is put in place?

Mr.V: No. **When they underperform is always for market reasons, or "macro" reasons.** From our perspective you have 3 factors, to have a good LBO, which will make the LBO thriving:

The first one is the **multiple**.

The second one is your **debt, your leverage.**

And the third one is your EBDA [**EBITDA**].

FG: Your EBITDA?

Mr.V: Yes. Ah sorry, yes.

FG: No, no problem yes.

Mr.V: So let's say your operational performance. **The only thing you can manage is your operational performance. Because you have nothing – nothing! – you have no influence on the multiple, it's something that is giving by the market, and no influence on the level of debt that the investment fund will be in a position to borrow, to make the acquisition.**

What I want to say here is that, of course, **the higher the multiple and the cheaper the interest on the debt… Well the more the price will be. It's mechanical. Independent from your operational performance.** And what is very frustrating is that**, you can have a company with a strong operational performance with a very poor price upon exit. It's just because of these market factors: multiple and debt; and you have nothing to do with that.**

So, unexpected reasons… Well, if your operational performance is poor, I would say it's something… Well, you just perform bad… That's it. **But the 2 other factors might be unexpected and it's very frustrating. Even if the packages are good, then your return will be poor if the multiples are bad. Or let's they have decrease from, I don't know, 7.5x to 6x… Then you lose a lot, you lose a lot because**

you have invested on the basis of 7.5 multiple and if they end at 6, well you are in a bad position. But it's nothing to do with you! It's just something that is exogenous. It's something that is given, that is imposed on you and it's very unfortunate. But that's it…

Well, then, then, then… What might happen is that during the next round, the new PE might try to upset this effect. But it's not sure, it's something that is based on their discussion… But you see, you might have a very good, very good package, a very good management, but because of exogenous factors everything goes wild.

Is that what you had in mind or?

FG: Yes… Yes… Or… So it's an underperformance, but not due to management's underperformance. It's due to external factors they can't control. So it doesn't normally happen that you put a management incentive package, and then managers underperform either by… I don't know… Not working hard I guess not, because I guess they'd just get fired but… Is there…?

Mr.V: No. It doesn't happen. It doesn't happen.

FG: Do they ever try to maybe cheat the system in some way? For example, I know back in the day – you already mentioned warrants and options are not used as much anymore – but management tried to, and it doesn't really happen in private companies because your share price is not fluctuating, but they would try to boost share price in order to maximise the return on their options. But I don't know if…

Mr.V: Well… Yes, no, no, you may have a kind of behaviour and of course… of course we have example where investment funds just acquired companies at insane prices, with no link to, or not legitimate ground, with respect to the company itself. But when you say unexpected reason… Operational performance might be anything. Let's say "Vivarte", you know Vivarte?

FG: Vivarte, yes.

Mr.V: A medium retailer in France, used to be a major retailer in France. And, and, they almost went bankrupt. And the reason for that, was a mix of bad performance… Bad performance, I don't know, it was during the crisis so… They were hoping to… They made a lot of investments, it was an over-leveraged structure, and unfortunately for them the crisis just struck them. Is that an unexpected reason? Maybe. And also, also, it was **heavily indebted. It had a lot, lot, lot, lot of debt. I think it was like 2.7 billion euros of debt, acquisition debt. Insane! Just insane!** And the… Well, because of those

2 factors… **the package was good, was extremely good by the way!** It was negotiated back in 2007. It was before the crisis, the July crisis. So, extremely good, very protective – very protective by the way – but it ended up worth nothing, because of the debt and because of the operational performance which just melted down. I think **the EBITDA went from 200-250 [million euros], down to almost 0.** Can you imagine? So it was like: "WOW!"

Is that unexpected? I don't know… The package was good, but unfortunately the management made mistakes and the debt structure was insane. **Usually we, we draw our client's attention when you have more than 4/5/7 debt-to-EBITDA.** Because more than that… phewww, might be very risky! If you have like a 7, a 7 debt-to-EBITDA ratio then… phewwww! You have to perform well to serve the debt. If you see what I mean?

FG: Debt-to-EBITDA you said?

Mr.V: Yes.

FG: Perfect. Perfect. And do you have any particular success and/or failure stories that would help categorise what makes an MIP effective?

Mr.V: Hmmm… That one is also a bit difficult because… What is important to bear in mind is, to make MIP effective or successful, is that you need someone to buy in a further round. It may sound a bit silly or obvious, but well… you need someone to buy. And from there, everything can happen.

If, for instance, if you have been for a long time in a transaction – when I say a long time, it's more than 5 years – **the time factor is very important because it can destroy a package.** Remember you have this fixed-rate instrument. **Fixed-rate instruments are extremely dangerous when you are in sweet equity. As the time goes by - can you imagine if you are 11-12% on your fixed rate instrument – can you imagine after 5-6 years how much… Well, just the basic effect of compounding interest can be very, very dangerous for your package.** So, I would say that when you have no-one who is willing to buy your company and you are stuck in a transaction, then you are in danger. You are in danger. For instance… You know Elis? Elis, the French industrial towel… It's like a clean-service. Industrial cleaning.

FG: Ok… What's it called sorry?

Mr.V: Elis. E-L-I-S, Elis. They made a huge acquisition in Brazil 2 years ago by the way. A strong build-up. And… they were stuck, the **management had been stuck for 8 years before they went public. So**

an LBO, so the PE house just sell it to make an IPO because, haha, they didn't find anyone willing to buy Elis. The big issue for them was not that they were underperforming, they were… well, good performer… but the debt structure was too, too heavy and, in addition, the fixed rate instruments had just captured all the value created. i.e. the performance was not sufficient to upset the compound interest on the fixed rate instruments.

So, the time, **time is very critical for a LBO transaction.** Because if this lasts too long, then **the fixed rate instruments – the equity which is structured as bonds, shareholder loans, preferred shares – will capture all the value.** Then of course bad performance… But bad performance, well of course it happens and you have stories. Ermmm… but I'm trying to figure out a client… Well bad performance as well, of course operational performance, but I think it's more than obvious…

But **time I think is something that is not so intuitive. It's not so obvious, but it's very important.** Because after 5 years you are just in a, in bad shape, in a bad position. Believe me.

FG: Sorry, this is probably my fault, but I'm struggling to understand… Why is it a problem with the fixed instruments? So, you are compounding the interest… Say you said you bought with interest of 12% return, yes?

Mr.V: Yes.

FG: Is this an annual return or is this an absolute return?

Mr.V: No, annual return. Yes. It's very practiced because you have "**thin capitalisation**" rule you have to comply with. So the **investment fund must sometimes – must – invest in equity! But then, they will make sure that their equity is not junior, so he will invest as a creditor. It will be, of course, junior to the banks but at least it will be senior to equity holders. And this is because of "thin capitalisation" rule, and if the rules are not complied with, then they will invest in preferred shares for instance, or alphabet shares**. **It's more a form of tax, rather than a financing issue.** You are trying to optimise your tax structure and your leverage, rather than your financing. No big deed here, **just trying to have a tax-efficient structure.**

FG: Because the fixed instrument you said is taxed more heavily? Than your capital gain?

Mr.V: No no no. "Thin Cap", you know "Thin Cap" rule? Thin Capitalisation.

FG: No, I'm not familiar with the term.

Mr.V: No? Ok, "thin cap" something that France and other countries impose on these kind of transactions. Where you are not allowed to have, I don't know, 90% of bank debt with 10% of equity. You usually have to have 60% of debt and 40% of equity.

FG: Oh, ok ok. So it's a leverage limit. A leverage rule.

Mr.V: Yes, absolutely. We call in "thin cap". **This is the reason why we have these bonds and so on. And also, also because the fund wants to make sure that they make at least an 11% return on their investment. It's more like a sort of cushion – a safety cushion – than anything else.** Because, as we know now and have mentioned before, **if you invest in fixed-rate instruments then your return is capped. It is senior to ordinary shares and other ratchet instruments**. And by the way, ratchet is junior to fixed-rate instruments. I think you know that, but just to make sure.

So, you are pretty sure that if everything – not goes well – but just goes, let's say, correctly, you will make your 11-12% return on your investment. Just to make sure. So, for **2 reasons you will structure your investment in fixed-rate instruments:**

First, because of thin cap.

And second, because you are trying to make sure that you achieve at least these 11-12%.

Usually the investment funds have an 8% threshold performance. **Below this threshold they don't make any carried interest. It's very important for them.** You see, so at least they have these 3, **3-4 points of performance, of delta, that you are sure to capture as an investment fund. In excess of your 8% threshold. Ok?**

FG: Yes. Sorry, I'm just struggling to fully comprehend what you were saying with the time… Why the fixed-rate instruments become a problem with time?

Mr.V: Oh. Ok. Just because, imagine you start with your investment, at 5 year fixed investment, at 5 years **your fixed-rate instrument will have generated, will have yielded, 12% each year or 11% each year on those instruments. Which is, after 5 years, I don't know if it double the value of those instruments, but it's not far from it. At 6 years, I think that the value of your instruments has just doubled.** And if you're not in a position – as management – if you are not in a position to have performed well, so various factors… **So if your IRR, for instance is at… I don't know, we have a fixed rate at 12, if your IRR is at 12 or 13%, then almost 99-100% of the value you will have created on the initial investment will be captured by compound interest.** Because upon exit – you know how it works

– upon exit someone will be acquiring, let's say for 100. **Out of these 100 – imagine you have 70% of your initial investment in fixed rate – so out of this 100, which the purchaser is willing to offer you for the equity, 70 will directly go to the fixed-rate. Plus, plus interest.** And if your interest have resulted in your fixed-rate instrument value being 2 times the initial value, then you are just, well, left with nothing if you have invested everything or almost everything in ordinary shares. **Because out of these 100, 70 goes directly to the fixed-rate instruments… But it's the exercise value, with no upside. Then you have to pay the upside of these different instruments.** Let's say, I don't know, it's 30 or 40… 30, then you're left with nothing with your ordinary shares. You see what I mean, so **time is very, very critical**. It's just a matter of, of you know, "waterfall" upon exit. **Because upon exit, someone who is paying 100 for the equity will acquire the fixed-rate instrument plus any accrued interest thereon, and then will acquire the ordinary shares. So the value that is left over, I would say. And it might be zero. So the compounding mechanism can be very, very dangerous! So the timing of the exit is critical, very critical.** And it might be not independent from operational performance, of course **if the operational performance is good it's obvious to say that the price will also be good. And then, even if you have been stuck with a pretty old transaction, then you will have sufficient value created to serve both fixed-rate instruments and the ordinary share**. But believe me, if this is not the case then **you might have performed rather well, if you are stuck with an old transaction and interest on fixed-rate instruments has been increased over the years, then you will be left with almost nothing.**

FG: Perfect.

Mr.V: Is that clear now?

FG: Yes, so you will basically make no money on your investment?

Mr.V: Yes, basically. Yes, you make nothing.

FG: You just make 100%. You'll just get back what you put in?

Mr.V: No, no, no, no, no. No, because if you are the management and you have decided to invest, let's say 80% in ordinary shares and 20% in fixed-rate instruments…

FG: Oh yes, of course…

Mr.V: No, no, you may be right. You may be right. **You may be right, you may end up with not losing everything but at least covering up, I don't know, 50% of your investment in ordinary shares, just because of the accrued interests.**

FG: Yes. So if it doubles, then you make 40% for example.

Mr.V: Yes. Exactly, so at least you cover a portion of your investment in ordinary shares. **This is exactly what happened with the manager in Brake. He lost everything in the shares, but because he had invested in 2008, he almost covered up all of his investment thanks to the accrued interest.** This is why we don't recommend to our clients to invest 100% in ordinary shares when you are in a sweet equity structure, because it might be very, very dangerous in the end. If you are not in a position to cover at least your investment. You see?

FG: Yes. Perfect.

Mr.V: You see that. It's very interesting…

FG: Absolutely! Yes! I was not aware – when I set out with this project – of all these aspects, so yes, this was an extremely helpful and interesting conversation. Thank you very much!

Mr.V: I hope so, yes. Haha

FG: Yes. And it's not stuff you find in the papers I've been reading or anything. So it's great to talk with someone who works in the field and is an expert in this area. This will definitely be of great value to my project.

Mr.V: What are you doing exactly? You are writing a paper, or you are…?

FG: Yes, I'm writing my thesis for my Masters.

Mr.V: Ok. Excellent so. What can I do then? Write it and then we can review that if you want. If you need me?

FG: Yes. Actually, I'm going to write-up this conversation. Would you like me to send a copy of the transcript when I'm done writing it up, for you to, if you'd like, check that everything I've written is correct and I haven't misunderstood or mistranscribed anything?

Mr.V: Yes sure. Well, but I trust you anyways, you can quote, you can… It's not an issue. But yes, send it.

FG: Ok. Thank you. And if you want, when I finish my report, I can send you a copy if it interest you. But, I mean, you work in this field, so it's…

Mr.V: No! I mean, it's always funny to take a step back and to reflect on it.

FG: Ok. And I have some interviews from the management's perspective, from CEOs and Directors of companies here, who have been on both the management side and the acquiring side. So it might give an interesting perspective as well on the matter.

Mr.V: Sure. What you have to understand is: **it all boils down to aligning interests.** Once you have said that… **Aligning interests is probably the motto we use the most in negotiations.** "Ah come on guys. We need to align our perspectives. We need to be aligned…" **Alignment, alignment… It's like our mantra.** Haha. "No guys, we're not aligned. This cannot work", "Oh, we just need to align our interests". It's just… probably the best way to align the interest of the management and the shareholder. From a pure governance perspective. But I leave it up to you and your more theoretical approach to assess it. Haha

FG: Perfect. Thank you very much.

Mr.V: Ok.

FG: Thank you so much for your time and I'll contact you through email if anything.

Mr.V: Yes sure. I look forward to receiving something from you then. Good luck!

FG: Thank you very much! Have a good day!

Mr.V: Bye!