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PwC's 2016 Private Equity Portfolio Company Management Compensation Survey

March 2016

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The heart of the matter

The median pool size of US-based private equity funds increased from 10% to 12% of fully diluted equity compared to recent studies.

For the first time since its 2005 launch, our survey of US-based private equity funds shows an increase in the median pool size —the result of a subset of participants that are extending equity participation deeper into the organization than the broader PE market, along with continued use of performance-based vesting conditions.

US private equity funds continue to operate in a robust, competitive investment market. With sponsors still participating in competitive auction processes, the management term sheet remains a critical part of the acquisition process.

Global buyout volume approached approximately $290b in 2015, representing a roughly 15% increase over the 2013/2014 levels, which were both approximately $250b.[1] Of this amount, approximately $140b was invested in the United States, the highest level since 2007. At the same time, global PE funds are estimated to have $700b reserved for leveraged buyouts heading into 2016.[2]

The combination of increased deal volume and cash reserves (dry powder) has financial sponsors regularly competing against one another in auction processes. The competitive dynamic also requires sponsors to compete across a wide variety of factors within the acquisition process, including leverage ratio, track record working with portfolio company management teams (“management”) and the competitiveness of the management term sheet. The parameters of the equity compensation plan, which establishes the pool size and vesting conditions, is a critical component of the term sheet and can be key to a sponsors’ bid.

Taking these factors into account, our survey of US-based private equity funds contains key plan design information for the equity compensation plans implemented by financial sponsors. In addition to analysis of equity compensation programs, this year’s survey includes analysis of cash compensation opportunities versus the public market and compensation considerations upon an Initial Public Offering (or “IPO”).

[1] Dealogic
[2] Capital IQ

An in-depth discussion

Big picture: Equity compensation trends and practices

Sponsors have begun to increase the size of equity compensation pools to push equity deeper into the organization, while continuing to use return-based performance conditions.

PwC's 2016 US Private Equity Portfolio Company Stock Compensation Survey highlights trends and practices in equity compensation design among US-based private equity firms. This year's survey includes data on 34 US-based portfolio companies acquired by 22 sponsors since January 2013.

From equity reserve increases to award vehicle prevalence: Survey highlights

Management equity pool reserves at the median have increased to 12% of fully diluted shares (up from 10% in earlier studies). The increase in the median share reserve is affected by a subset of participants that are extending participation deeper in to the organization. Share reserves range from 10%- to-15% and are generally inversely related to the size of the sponsor's equity investment.

Sponsors continue to tie award vesting to performance-based conditions. More than 80% of firms tie at least a portion of awards to the sponsor's financial return upon exit. Most often, the majority of awards (50% to-75%) will vest on the basis of performance, with the remainder vesting ratably over five years. Full vesting generally requires achieving an Internal Rate of Return (IRR) of 25% or a Multiple of Invested Capital (MOIC) of 3.0x (and in some cases, both).

Stock options remain the most prevalent form of equity compensation used by financial sponsors. "Upside only" awards, which reward executives only for the growth in equity value, most directly tie the incentives of management with the sponsor. Portfolio companies that are structured as partnerships may issue profits interests, which are economically comparable to stock options but allow participants to realize capital gains tax rates (rather than ordinary income tax rates).

Participation is generally limited to the two- to-three most senior layers of management. Across sponsors that made equity investments of $100m and above, median participation in the equity plan is approximately 27 employees, or about 3.7% of the total employee base. However, we see variance among industries. The median participation among retail and hospitality business was about 2.1%, compared to technology and life sciences respondents where the median participation rate was about 6.9%.

Cash compensation (salary plus annual bonus opportunity) for executives at sponsor-backed companies is generally aligned with market competitive pay levels for public company executives. This finding runs counter to the historical perception that sponsor-backed companies pay less in cash compensation, while providing significant upside in the equity awards. In instances where strong investment returns lead to full vesting of performance-based awards, equity awards for executives at sponsor-backed companies typically exceed those opportunities for executives at comparably-sized public companies.

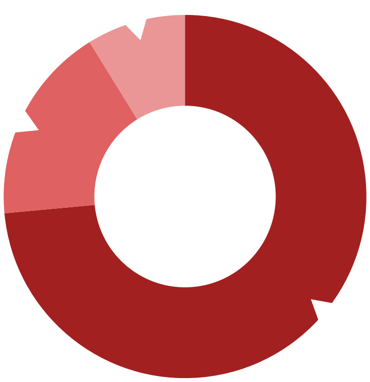
Baby, you can drive my growth: Award vehicles and levels

Stock options, which reward management for growth in equity value, remain the primary award vehicle for financial sponsors.

Reflecting our findings in previous studies, US private equity funds continue to rely on award vehicles that are tied to the growth in equity value. These "upside only" awards most directly align the incentives of management with the sponsor, which is compensated by LPs based on the growth in equity value.
Among our survey population, more than 90% of plans use stock options or profits interests as the primary incentive vehicle.

Profits interests, which are economically comparable to stock options, can be granted only by those organizations that are structured as partnerships. However, participants who receive profit interests are generally taxed at capital gains rates (rather than ordinary income, as is the case with stock options). The decreased individual tax rates for participants would, in theory, allow sponsors to grant a smaller equity pool for a given level of post-tax benefits. On the flip side, the company does not receive a corporate income tax deduction upon the liquidation of profit interests upon a sale. As such, the value of that deduction will not be considered during the ultimate sale process.

Financial sponsors continue to avoid using full value awards, such as restricted stock (or restricted stock units), due to the less favorable tax treatment to the individual and less direct alignment of interests (whereby participants realize some level value irrespective of equity appreciation).



Breaking with tradition: Share reserve pools up

Compared to previous studies, the median share reserve across portfolio companies has increased to 12% of fully-diluted equity, from historical levels of 10%.

As noted earlier, for the first time since PwC began conducting this survey in 2005, we observed an increase in equity incentive award pools. Historically, many funds have defaulted to the industry standard reserve of 10%. However, as the maximum reserve pools reflect full vesting, the increased pool size is tied to both the aggressive performance vesting goals and increased participation. Several sponsors indicated that they are happy to increase pool size because if management achieves the performance conditions required for full vesting, it means that the investment was very profitable for the fund.

The range of pool sizes generally extends from 10%- to-15% (from the 25th to 75th percentile). As expected, we see a slight but clear inverse relationship between the size of the equity investment and the share reserve. However, some larger companies have been expanding participation in recent years, limiting the gap in pool size. Many sponsors indicated that the pool reserve is a function of negotiations and historical practice at the fund and/or the portfolio company. Most sponsors use the pool size to guide grant levels but do not take a refined "bottoms up" approach to determining target compensation value.

	Equity reserved for management		
Equity investment	25th	50th	75th
Greater than $300m	10%	12%	14%
Between $100m - $300m	10%	13%	15%
Less than $100m	n/a	15%	n/a
All Data	**10%**	**12%**	**15%**

Concentrate: Equity grants to senior executives

Across our sample, the CEO generally receives options on about 2% of fully diluted equity (at the median), based on the data provided. The number two executive most often receives 40%- to-50% of the CEO's equity interest. Grants to the remainder of the key management team, defined as the top five executives, generally level off at about 0.5% of fully diluted equity, but are highly dependent on the organizational structure.

Based on our experience working with sponsors, funds may try to determine the value of awards for the CEO and then "back into" the number of shares using the base investment case. CEOs are then often given discretion to make recommendations to the sponsor as how to allocate awards for the remainder of the participating population within the bounds of the share reserve and equity grant strategy.

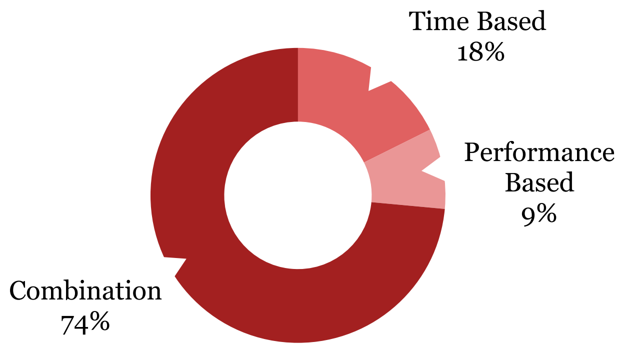
Further, sponsors allocate the majority (about 73% at the median) of shares in the overall pool at the time of acquisition, leaving a relatively modest equity pool available for executives hired after the initial investment or to reflect increased individual responsibilities upon promotion.

	Percent of fully diluted shares		
	25th %ile	50th %ile	75th %ile
CEO	1.5%	2.1%	4.4%
#2 Executive	0.5%	1.0%	1.1%
#3 Executive	0.4%	0.5%	0.9%
Pool Reserved for Future Grants	**20%**	**27%**	**35%**

You've got to earn it: Award vesting and performance goals

Funds continue to tie award vesting to exit returns, most commonly attaching performance vesting conditions to 50%- to-75% of awards granted

Consistent with prior studies, financial sponsors continue to tie a significant portion of award vesting to performance goals. In the 2016 study, 83% of companies tied a portion of awards to performance, representing a slight uptick over 2013 survey results, in which we found that about 78% of companies had performance-based vesting conditions. The larger the equity investment, the more likely that a sponsor would attach performance vesting conditions to equity awards.



At the median, companies with performance-based vesting conditions are tying approximately 60% of award value to such conditions. The most common split among participants is to provide either 25% or 33% of award value with time-based vesting conditions and attach performance vesting conditions to the remainder of awards. However, a fair number of respondents divide grants equally between time- and performance-based vesting (50%/50%). Time-based awards most commonly vest over five years.

The shift to performance-based awards over the last five- to-eight years among plans implemented by financial sponsors is consistent with public company executive compensation awards, according to PwC's Global Equity Incentives survey.

Metrics matters: Performance-based vesting criteria

Full vesting of performance-based equity awards could require achieving an IRR of 25%, a MOIC of 3.0x—or both.

Of the companies with performance-based vesting criteria, some 70% used exit-based performance metrics such as a MOIC or IRR, or a combination of both. Other metrics included EBITDA performance or absolute enterprise value growth, which is analogous to MOIC.

While the pool size of incentive plans has increased, the equity growth performance goals required to achieve full vesting have become more aggressive. Based on the aggregated data we collected, companies with IRR performance metrics generally allow for partial vesting at 15% and maximum vesting only when a return of 25% is achieved. Similarly, for companies with MOIC plans, vesting may begin with a MOIC of 2.0x, but maximum vesting does not occur unless a MOIC of 3.0x is achieved. Approximately one-third of respondents require the achievement of both MOIC and IRR performance goals in order to achieve full vesting under the plan.

These plan structures, along with the increased share pools, are intended to render sponsors willing to share gains with management at levels beyond historical norms, provided that they are able to show substantial returns to investors.

The table here illustrates a representative plan for the many companies that use a "three tranche" approach to vesting:

% of awards	*Vesting*	*Requirements*
33%	Time	5 year graded
33%	Performance	20% IRR AND 2.0 MOIC
33%	Performance	25% IRR AND 3.0 MOIC

PwC Perspective

While they are fundamentally similar, the choice of whether to use IRR or MOIC to measure performance can have significant implications for the sponsor and the management team. Plans with vesting tied solely to MOIC alleviate the time pressure to show results and deliver a quick exit necessary to achieve a high IRR. However, as the table illustrates, a high MOIC after seven- to-eight (or more) years is unlikely to deliver a return consistent with investor expectations. Many larger sponsors have structured awards that are tied to achievement of both IRR and MOIC targets to earn full vesting under the plan.

The table shows the correlation between IRR in the year of exit and the MOIC achieved at such exit date. The grey line illustrates a hypothetical vesting threshold for performance-based awards at a MOIC of 2.5x original investment.

	IRR in year of exit									
MOIC	1	2	3	4	5	6	7	8	9	10
1.00	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
1.25	25%	12%	8%	6%	5%	4%	3%	3%	3%	2%
1.50	50%	22%	14%	11%	8%	7%	6%	5%	5%	4%
1.75	75%	32%	21%	15%	12%	10%	8%	7%	6%	6%
2.00	100%	41%	26%	19%	15%	12%	10%	9%	8%	7%
2.25	125%	50%	31%	22%	18%	14%	12%	11%	9%	8%
2.50	150%	58%	36%	26%	20%	16%	14%	12%	11%	10%
2.75	175%	66%	40%	29%	22%	18%	16%	13%	12%	11%
3.00	200%	73%	44%	32%	25%	20%	17%	15%	13%	12%
3.25	225%	80%	48%	34%	27%	22%	18%	16%	14%	13%
3.50	250%	87%	52%	37%	28%	23%	20%	17%	15%	13%

Example vesting hurdle of 2.5x MOIC

If award vesting is tied only to MOIC….

Achieving an IRR of 22% (after 4 years) would not result in award vesting….

While achieving the MOIC hurdle 4 years later would result in vesting at an IRR of 12%

Mission critical: Depth of participation

Sponsors continue to limit participation to employees who are viewed as critical to the success and growth of the company. Companies with larger share reserve pools are extending equity participation deeper into the organization.

Among equity investments of $100m+, approximately 27 employees (or 3.7% of total employees) participate in the plan, at the median. This group generally reflects CEOs' direct reports and the next 1-2 layers of management within the organization. However, we see variance in participation levels across industries based on workforce composition. To illustrate, the median participation among retail and hospitality business was about 2.1%, compared to technology and life sciences respondents where the median participation rate was around 6.9%.

Among companies with larger pool sizes (15% and greater), the median participation rate increases to about 7%, compared to 3.7% across the broader survey). Several of these respondents reported 40 or more employees in the management equity pool. Deep participation in equity pools may reflect a recognition by sponsors that equity incentives delivered historically may need to be replaced via cash or equity post-transaction.

Many sponsors, however, express concern about whether middle management values participation in plans without a clear path to liquidity and limited transparency. As such, sponsors may choose to provide enhanced annual incentives or a supplemental cash long-term incentive plan for these employees (which may be tied to exit). This is particularly true in the case of leveraged buyouts of public companies where equity historically extended deeper into the organization.

PwC Perspective

While non-cash stock compensation expenses are typically added back to earnings for the purposes of valuation during the diligence process, sponsors should consider the costs associated with any "replacement" plans that may be implemented post-transaction. This is particularly true when the purchase agreement requires that levels of compensation be maintained for a period of time following closing. Expenses related to any cash replacement plans should be considered within the deal model, even if the exact details of the plan are not known during diligence.

The schedule here shows how a sponsor may split a target company's population when considering future equity and long-term incentives.

Average grant date fair value of equity awards by Individual

Grade	Average salary ($)	# EEs	2013	2014	2015	3-yr average
10	$ 1,300,000	1	$ 1,210,000	$ 1,260,000	$ 1,300,000	$ 1,255,000
9	600,000	1	$ 420,000	$ 435,000	$ 450,000	$ 435,000
8	630,000	3	$ 295,000	$ 305,000	$ 315,000	$ 305,000
7	500,000	7	$ 235,000	$ 245,000	$ 250,000	$ 245,000
6	278,000	15	$ 105,000	$ 110,000	$ 110,000	$ 110,000
5	172,000	241	$ 40,000	$ 40,000	$ 45,000	$ 40,000
4	136,000	399	$ 30,000	$ 35,000	$ 35,000	$ 35,000
3	107,000	295	$ 10,000	$ 10,000	$ 10,000	$ 10,000
2	88,000	258	$ 10,000	$ 10,000	$ 10,000	$ 10,000
1	75,000	280	$ 5,000	$ 5,000	$ 10,000	$ 5,000
Aggregate Grant Date Fair Value		**1,500**	$ 34,300,000	$ 36,500,000	$ 39,200,000	$ 36,700,000

The most senior 27 employees participate in the equity plan post-transaction

Certain middle managers may participate in a cash long-term incentive plan

Equity awards for junior employees may not be replaced post transaction

Certain figures above are rounded for illustrative purposes.

All things being equal: Compensation levels

Salary and bonus for executives of privately held companies have long been thought to trail cash compensation levels for executives at comparable, public companies. Yet our study found that cash compensation levels are comparable across ownership structures. Equity compensation opportunities at sponsor-backed companies continue to exceed those packages for public company executives, however.

Equity compensation opportunities for executives at sponsor-backed companies can often yield significantly greater rewards than public company equity compensation programs, as a result of the leveraged capitalization structure and associated risk premium. In previous studies, we analyzed the expected value of equity grants made to the CEO of portfolio companies, relative to the awards that could otherwise be expected in the broader market (using survey and proxy data). Assuming investment returns of 2.5x MOIC, the median expected payouts for CEOs at sponsor- backed companies lead those at comparable public firms by up to 3.0x. However, this analysis assumes a successful exit and does not consider low growth scenarios, whereby a public company executive would realize value of liquid equity awards and a portfolio company executive may realize limited value from a sponsor-backed plan.

Cash Compensation Levels: Many industry insiders and compensation consultants have contended that cash compensation (salary plus bonus) for executives at sponsor-backed companies trail earnings opportunities for executives at public companies.

However, based on the executive compensation data submitted, salary levels for private company CEOs and CFOs are very closely aligned (+/- 5%) with pay levels for public company executives. Further, bonus opportunities for executives at sponsor-backed companies led target award levels for public companies, resulting in total cash compensation of some 20% above market median levels. Further, the performance targets required to earn a full target bonus at sponsor- backed companies may be more “stretching” than the targets at public companies.

Factoring in Risk: Finally, while rewards for executives at sponsor-backed companies lead pay packages at public companies economically, according to PwC’s global study on the effectiveness of incentives (the “Psychology of Incentives”), executives globally are putting a discount on the value of their equity incentives. The study found that executives place a very high value on structures that are easily understandable and controllable. Specifically, 50% more executives choose a clearer pay package than a more ambiguous one of the same or potentially higher value. Additionally, two-thirds more executives prefer an internal measure they can control (such as profit) as opposed to an external relative measure (such as total shareholder return). Because the study was performed globally across industries, it's unclear if the results are directly applicable to US portfolio company executives. However, it would stand to reason that the risk associated with the sponsor-backed company and the uneconomic discount that executives place on illiquid equity awards explains the risk premium paid.

PwC Perspective

Management may be able to "trade" cash for equity in a way that is mutually beneficial to both management and the sponsor, depending on the economics of the transaction. Decreasing cash compensation levels post-buyout results in an increase to EBITDA and frees additional cash to pay down debt and lower interest payments over the holding period of the company.

In the simplified example shown here, management forfeits $500k in cash compensation per year (or $100k for five people) in exchange for an additional 2% of fully diluted equity. At the time of exit after five years, equity value has increased by $6.0m over the baseline scenario as a result of $2.5m of additional debt pay down and a 7.0x EBITDA multiple on the $500k of increased earnings. The increased growth in equity value allows for both the sponsors and management to realize greater proceeds on exit (even when accounting for the cash compensation forfeited).

Although many purchase agreements provide for comparability of compensation levels post-close, acquirers may choose to carve-out employees earning over a certain threshold in order to pursue such a strategy.

	On acquisition	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5/Exit*
Earnings	$ 100,000	$ 105,000	$ 110,500	$ 116,000	$ 122,000	$ 128,000
Plus Salary Savings		$ -	$ -	$ -	$ -	$ -
	Total Earnings	$ 105,000	$ 110,500	$ 116,000	$ 122,000	$ 128,000
Debt	$ 500,000	$ 500,000	$ 500,000	$ 500,000	$ 500,000	$ 500,000
Equity	$ 200,000					$ 396,000
Enterprise Value	$ 700,000					$ 896,000

	Equity pool	*Proceeds*
Sponsor	90%	$ 176,400
Mgmt Equity	10%	$ 19,600
	100%	$ 196,000

	On acquisition	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5/Exit*
Earnings	$ 100,000	$ 105,000	$ 110,500	$ 116,000	$ 122,000	$ 128,000
Plus Salary Savings		$ 500	$ 500	$ 500	$ 500	$ 500
	Total Earnings	$ 105,500	$ 111,000	$ 116,500	$ 122,500	$ 128,500
Debt	$ 500,000	$ 499,500	$ 499,000	$ 498,500	$ 498,000	$ 497,500
Equity	$ 200,000					$ 402,000
Enterprise Value	$ 700,000					$ 899,500

	Equity Pool	*Proceeds*	*Gain vs. Baseline*	*Compensation Reduction*	*Net Gain*
Sponsor	88.0%	$ 177,760	$ 1,360	$ -	$ 1,360
Mgmt Equity	12.0%	$ 24,240	$ 4,640	$ (2,500)	$ 2,140
	100.0%	$ 202,000	$ 6,000	$ (2,500)	$ 3,500

Note: This illustrative example assumes annual earnings increase of 5% per year and assumes that the earnings multiple of 7.0x EBITDA is held constant over the course of the investment. Also, note that additional factors such as taxes, time value of money, and impact of longer holding periods were not considered.

Capital gains: Planning for exit via IPO

Financial sponsors continue to exit investments via the capital markets; requiring changes and careful planning for executive compensation programs.

The US IPO market remained strong in 2015 with 196 listings that raised $33.2B, following a record 2014 that saw 304 IPOs that raised $87.1b (bolstered by several large listings). Of the 2015 listings, approximately 110 were backed by either financial sponsors or venture capital firms. Those companies that have performed well upon initial public offering in 2014 and 2015 include companies exhibiting strong brand value (particularly with respect to consumer goods) and businesses with dependable cash flow, both of which are common features among many PE portfolio companies.

In preparation for an IPO, companies must perform a detailed review of the existing awards program in addition to establishing a "go forward" rewards program. We'll look at several of the key focus areas:

- ***Impact of IPO on existing LTI awards:*** It's critical to understand the impact of the listing on the outstanding awards well in advance of the offering. Depending on the plan terms, awards may be subject to accelerated vesting, or alternatively, they may remain subject to the original, valuation-based vesting metrics. If awards are not expected to vest upon the IPO, it will be critical to understand and communicate to participants any changes to the outstanding awards and how performance will be measured for the purposes of vesting as a public company.

  Treatment of awards upon IPO are generally dictated within the equity incentive plan document and, in many cases, the plan may use a concept of "implied equity value," whereby vesting is determined by the overall valuation upon the offering. Additionally, sponsors may continue to measure return (for purposes of determining IRR-based vesting) on the basis of proceeds realized on the initial public offering and any subsequent sales into the public market. This provision can create friction between management and the sponsor in the event that the sponsor realizes liquidity in advance of management. Finally, senior executives may realize significant equity gains upon an IPO; this could create retention challenges in the absence of meaningful share ownership guidelines.

- ***Peer group and benchmarking:*** Public company shareholders will expect compensation to be benchmarked relative to a group of comparably-sized industry competitors (i.e., the peer group). The company should identify the peer group constituents and benchmark current compensation levels and rewards structure in advance of the offering. By doing so, the company will be able to proactively address any gaps to market via the Compensation Discussion and Analysis section of the proxy statement. Peer groups are required to be disclosed by companies that do not qualify as Emerging Growth Companies (typically companies with annual revenues of less than $1.0b).

- ***PublicCo equity compensation plan and strategy:*** In conjunction with the IPO, most companies take the opportunity to revisit the structure of the executive rewards program to confirm that it's appropriate for a public company and aligned with business objectives. Further, the details of the compensation structure and executive arrangements will be disclosed in the Compensation Discussion & Analysis narrative within the S-1 and future proxy statements. As such, companies need to establish a clear story behind the structure and purpose of the executive compensation program.

  – ***New performance metrics:*** Companies may need to modify performance goals under the annual incentive plan, which are traditionally earnings based or a US GAAP-based measure such as EPS. Alternatively, the goals may be modified to create consistency with the message to shareholders (i.e., aligned with revenue growth, cost savings, or expansion).

  – ***Equity plan design and share reserve:*** Prior to listing, companies will reserve shares to be granted under the public company equity compensation plan. Careful planning is required to confirm that the share reserve is reasonable compared to the public market and sufficient to last for several years, such that the company will not need to seek shareholder approval for an additional reserve within the first few years of operation as a public company. Many companies will use the listing and the public currency to extend equity further down into the organization to certain employees who have not participated historically.

– The fundamental design of a public company equity compensation program differs significantly from that of a sponsor backed company. Some of the key differences of typical market practice are highlighted here:

	Sponsor-backed	*Public company*
Awards	• Options	• Combination of performance- and time-based RS/RSUs & stock options (variance by industry)
Grant Frequency	• Mega-grant at time of acquisition (limited add-on for promotion/new hires)	• Annual grants
Share Reserve/Burn Rate	• Median reserve of 12% in survey	• 0.5%-2.0% of market capitalization annually (significant variance by company, industry, size)
Participation	• Limited to most senior levels of management	• May extend deep into management levels of organization
Liquidity	• Only upon exit	• Easily liquidated in public markets following vesting
Retention Mechanism	• No liquidity until exit	• Executive share ownership and/or retention requirements

– ***Executive employment agreements:*** *Existing employment agreements should be reviewed and modified to reflect public company practices. Companies may try to negotiate the elimination of excess benefits, perquisites, or severance protection terms that are typically not well received by public shareholders.*

– ***Governance:*** *Newly public companies are required to form a Compensation Committee with independent members of the Board of Directors. The Compensation Committee is responsible for determining the overall rewards strategy and approving compensation packages for officers. Additionally, the Committee will generally engage an independent compensation consultant to assist with developing a peer group and benchmarking compensation levels and structure relative to the market.*

- **Technical reviews ("cheap stock" & IRC Section 409A):** Prior to listing, the company should review the methodology and documentation used to support the fair-market value for the purposes of historical equity compensation grants. Upon the S-1 filing, the SEC will review the amount of expense incurred historically and may comment on the valuation of such awards. Examples of such comments are shown here:[3]

– *Please supplementally provide us with a quantitative and qualitative analysis explaining the difference between the estimated offering price and the fair value of each equity issuance through the date of effectiveness for the preceding twelve months.*

– *You cite improved capital market conditions for companies in your industry as a reason for the increase in fair value, reflected in the estimated IPO price. Please explain to us why you were unaware of this information and presumably did not include it in your September 2014 common stock valuation.*

– *Further, depending on the fair-market value upon listing, there may be questions as to whether the stock was appropriately valued for the purposes of determining exercise price under Internal Revenue Code (IRC) Section 409A. This could result in tax penalties to the individual and required disclosures for the company.*

[3] Stay Informed: 2014 SEC comment letter trends: Employee Stock Compensation (PwC)

What this means for your business

Structuring management equity plans continues to evolve and increase in complexity within the context of a competitive buyout market.

Historically, sponsors were likely to establish a management incentive plan with a standard 10% option pool and consider themselves to have aligned interests of all parties. However, plans have become significantly more nuanced and complex through the continued use of performance-based vesting conditions. Specifically, plans that tie vesting to achievement of both IRR and MOIC confirm that management will be paid only in the event that investors realize significant returns. These vesting conditions, combined with deeper participation among some companies, have led to an increase in share reserve at the median, demonstrating that sponsors are willing to share gains with management at levels beyond historical norms, provided they are able to show substantial returns to investors.

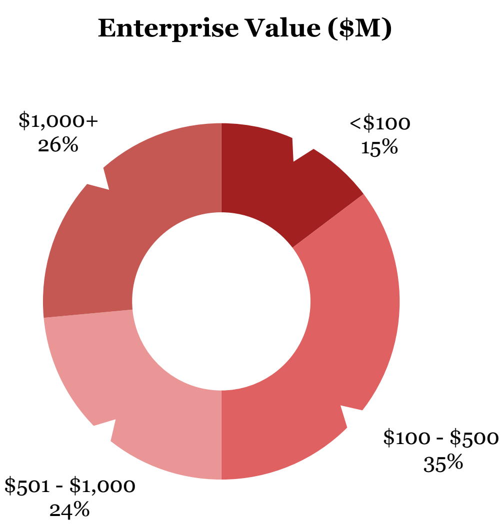
The increased use of the capital markets as a means of exit has led financial sponsors to consider the impact of an initial public offering well in advance of the listing. While the focus of these IPO readiness efforts often center around financial reporting, governance, and disclosure, the impact of the transaction on current and future executive rewards programs must be carefully considered. The impact of the listing on current incentive structures, along with the challenges and opportunities created by a public equity “currency,” requires careful planning to promote success through disposition for the sponsor while establishing the framework for continued success as a public company.

Appendix: Methodology and participant demographics

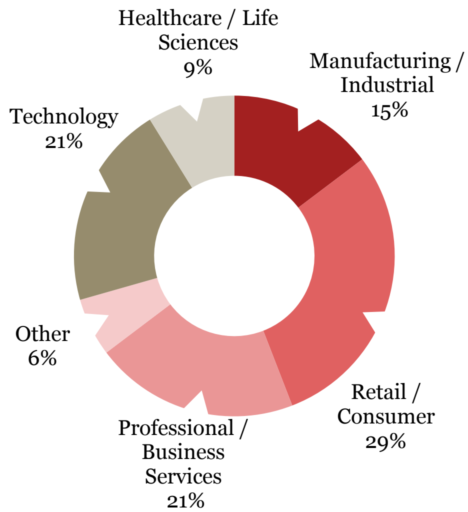
For the 2016 survey, PwC collected and analyzed data on the equity compensation plans of 22 US-based private equity firms used at 34 portfolio companies acquired between January 1, 2013 and July 31, 2015. Data were primarily collected via an excel-based questionnaire or response to a data request for key information. Respondents were not required to answer every question in the survey. To preserve confidentiality, the participant list or details of the portfolio companies studied have not been provided.

These tables summarize the respondent set profile:

By deal size



By industry



Comparison with 2013 results

Category	*2013 survey*	*2016 survey*
Equity Award Vehicles	**Stock Options:** 70% **Profits Interests:** 23% **Other:** 7%	**Stock Options:** 74% **Profits Interests:** 18% **Other:** 9%
Share Reserve Pools	**25th Percentile:** 8% **50th Percentile:** 10% **75th Percentile:** 14%	**25th Percentile:** 10% **50th Percentile:** 12% **75th Percentile:** 15%
Top 3 Executive Grants (at 50th percentile)	**CEO:** 2.0% **#2 Executive:** 1.0% **#3 Executive:** 0.7%	**CEO:** 2.1% **#2 Executive: 1.0%** **#3 Executive:** 0.5%
Vesting	**Time - Only:** 18% **Performance - Only:** 9% **Combination of Time & Perf:** 74%	**Time - Only:** 23% **Performance - Only:** 8% **Combination of Time & Perf.:** 70%
Performance Metrics	**Exit-based (MOIC/IRR):** 65% **Combination (Exit & financial):** 35%	**Exit-based (MOIC/IRR):** 70% **Combination (Exit & financial):** 30%
Deal Size (Enterprise Value)	**<100m:** 14% **$100m - $500m:** 46% **$500m - $1,000m:** 18% **>$1,000m:** 21%	**<100m:** 15% **$100m - $500m:** 35% **$500m - $1,000m:** 24% **>$1,000m:** 26%

Note; figures may not add to 100% based on rounding.

For further information

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