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Management Incentive Plans in PE: Rollover Equity, Ratchets, and the Promote

Rollover equity mechanics and tax treatment, the management equity pool, sweet equity ratchets, the promote structure, and the financial modeling to understand and negotiate management economics

WHAT YOU WILL LEARN AND WHY IT MATTERS

The management incentive plan — the equity and equity-like compensation structure that the PE sponsor uses to align the management team with the value creation agenda — is one of the most important and most complex financial governance topics for the PE company CFO. The CFO is simultaneously a participant in the management incentive plan (as a member of the management team who receives equity compensation) and the financial officer responsible for managing the plan's accounting, tax, and governance obligations.

Understanding the financial mechanics of PE management incentive plans — the rollover equity that the selling management team contributes, the sweet equity that the management team receives as incentive compensation, the ratchet structures that adjust the equity allocation based on the PE fund's return, and the promote that gives the management team disproportionate upside above specified return thresholds — is essential for the CFO both in negotiating the personal financial terms at the time of the PE acquisition and in managing the ongoing governance obligations throughout the holding period.

ROLLOVER EQUITY: MECHANICS AND TAX TREATMENT

Rollover equity is the equity that the management team contributes to the PE acquisition by rolling over a portion of their proceeds from the sale of the company into the new PE-owned structure rather than taking cash at closing. Rollover equity is one of the most important alignment mechanisms in a PE acquisition — by requiring management to invest alongside the PE fund, the PE sponsor ensures that management's financial interests are directly tied to the equity value of the new company.

THE ROLLOVER MECHANICS: The rollover process typically works as follows: at the time of the PE acquisition, the management team receives the same per-share acquisition consideration as all other shareholders. However, instead of taking this consideration entirely in cash, the management team agrees to re-invest a specified portion — typically ten to twenty percent of their after-tax proceeds — into the new PE-owned company as equity. The rollover equity is typically invested at the same price per share as the PE fund's equity contribution, giving management the same entry valuation as the PE sponsor.

THE TAX TREATMENT OF ROLLOVER EQUITY: The tax treatment of rollover equity is one of the most complex areas of PE transaction tax planning. The fundamental question is whether the rollover is structured as a tax-free reorganization (in which the management team defers the recognition of gain on the shares rolled over until the PE-owned company is eventually sold) or as a taxable exchange (in which the management team recognizes gain at the time of the rollover but typically at capital gains rates). The CFO must work with the company's tax advisors to understand the specific tax treatment of any rollover equity before committing to the rollover structure, because the after-tax economics of the rollover can be substantially different from the pre-tax economics depending on the structure chosen.

SWEET EQUITY AND RATCHET STRUCTURES

Sweet equity — also called management equity or incentive equity — is the equity interest granted to the management team in the PE-owned company, typically at a nominal value or at a discount to the PE fund's entry value. Sweet equity gives management the opportunity to participate in the upside of the company's value creation above the PE fund's entry value, creating the alignment between management's financial interests and the value creation agenda that is the fundamental purpose of PE management incentive plans.

THE SWEET EQUITY STRUCTURE: Sweet equity is typically structured as a separate class of shares (the management shares) that ranks alongside or just below the PE fund's equity in the ownership waterfall. The economic terms of the sweet equity are structured so that management receives a disproportionate share of the upside — a greater percentage of the equity value above the PE fund's return threshold than the percentage of the total equity that management's shares represent. This disproportionate participation is achieved through one of several structural mechanisms: the ordinary shares structure (where management's ordinary shares rank *pari passu* with the PE fund's shares but the fund receives a preferred return first), the ratchet structure (where management's percentage of the equity increases if the PE fund achieves specified return thresholds), or the promote structure (where management receives a percentage of the profits above a specified return hurdle).

THE RATCHET MECHANISM: A ratchet is a contractual adjustment mechanism that changes management's percentage of the equity based on the PE fund's ultimate return. A typical ratchet might specify: if the PE fund achieves a two-times return on invested equity, management receives twenty percent of the equity; if the PE fund achieves a three-times return, management's percentage increases to twenty-five percent; if the PE fund achieves a four-times return or more, management's percentage increases to thirty percent. The ratchet creates a powerful financial incentive for management to maximize the PE fund's return — every marginal improvement in the PE fund's exit multiple increases management's equity percentage and therefore management's personal financial outcome.

MODELING THE MANAGEMENT ECONOMICS: The CFO must build a financial model that calculates management's economic outcome under every combination of exit enterprise value and holding period. This model — which requires the full exit waterfall analysis from Part Twenty, combined with the management equity percentage calculation from the ratchet schedule — tells the CFO exactly how much money the management team receives at different exit valuations and helps inform the negotiation of the management incentive plan terms at the time of the PE acquisition.

THE PROMOTE STRUCTURE

The promote — also called a carried interest in a management context — is the mechanism by which the management team receives a disproportionate share of the equity value above a specified return hurdle. Unlike the ratchet (which adjusts the management team's percentage of the total equity), the promote gives management a percentage of the profits above the hurdle, regardless of the management team's initial equity percentage.

A typical promote structure might specify: the PE fund receives the first return of its invested capital plus an eight percent preferred return; thereafter, management receives twenty percent of all additional profits and the PE fund receives eighty percent. This structure creates a financial incentive similar to the carried interest structure used for the GP of a PE fund: management is motivated to maximize the value of the PE fund's equity above the preferred return threshold, because every dollar of value above the threshold results in management receiving twenty cents.

THE PROMOTE VERSUS RATCHET CHOICE: The choice between a promote structure and a ratchet structure has important financial modeling implications. The promote structure is typically more valuable to management in very high return scenarios (where the profits above the hurdle are large) but less valuable in moderate return scenarios (where the profits above the hurdle are modest). The ratchet structure is typically more predictable — management's percentage is specified at each return threshold — but may be less valuable in the highest return scenarios than a well-structured promote. The CFO should model both structures across the full range of expected exit scenarios before committing to one or the other in the management incentive plan negotiation.

ONGOING ACCOUNTING AND GOVERNANCE OBLIGATIONS

The management incentive plan creates ongoing accounting and governance obligations that the CFO must manage throughout the holding period. These obligations are distinct from the ASC 718 obligations for option grants (which apply to the management team's option grants at the portfolio company level) and reflect the specific characteristics of the rollover equity, sweet equity, and promote structures.

ACCOUNTING FOR SWEET EQUITY: If the sweet equity is granted to management at a value below fair market value, the difference between the fair value and the grant price represents compensation that must be recognized as expense under ASC 718. The fair value measurement of PE sweet equity is complex — it requires a valuation of the management shares that reflects the specific economic terms of the sweet equity (the disproportionate participation above the preferred return threshold, the ratchet or promote structure) — and typically requires the engagement of a valuation specialist.

THE SECURITIES LAW CONSIDERATIONS: The management incentive plan must be structured in compliance with the securities laws that govern the issuance of equity to management team members. In most PE transactions, the sweet equity is issued under an exemption from SEC registration — either the Rule 701 exemption for equity grants to employees under a compensatory plan or the Regulation D exemption for offers to accredited investors. The CFO must ensure that the issuance of sweet equity to

each management team member is properly documented and that the applicable securities law exemption conditions are satisfied.

ACTIONS TO TAKE BEFORE PART TWENTY-THREE

Build the management economics model: a complete waterfall analysis that shows the economic outcome for each member of the management team at each combination of exit enterprise value (ranging from the current enterprise value to three times the acquisition enterprise value) and holding period. Present this model to the CEO and the management team before the next board meeting as the shared analytical framework for understanding the personal financial implications of the value creation decisions during the holding period.

Review the accounting for the sweet equity grants: confirm that the fair value of each management equity grant has been properly determined, that the compensation expense (if any) has been correctly calculated under ASC 718, and that the grant is properly documented in the cap table. If any of these elements are unclear or incomplete, engage the external auditors or a valuation specialist to complete the accounting analysis before the next annual audit.

CLOSING PERSPECTIVE

Management incentive plans in PE are the financial mechanism that aligns the management team's personal economic interests with the value creation objectives that determine the PE fund's return. The CFO who understands these mechanisms — who can model the management economics across the full range of exit scenarios, who manages the accounting and governance obligations with precision, and who negotiates the terms with the analytical preparation required to secure the most favorable alignment of incentives — is managing one of the most consequential financial governance obligations of the PE holding period.

COMING NEXT IN THE SERIES

Part 23 — Add-On Acquisitions: Platform and Bolt-On M&A; in PE-Owned Companies

Part Twenty-Three covers the buy-and-build strategy from the PE portfolio company CFO's perspective — the financial criteria for add-on acquisitions, the accelerated due diligence process for bolt-on transactions, the integration finance for add-on deals, the goodwill and purchase accounting accumulation across multiple acquisitions, and the combined company financial model that tracks the platform's growing scale.