Your Company is being bought by private equity—Is that good or bad for you as CEO?

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Some chief executive officers become excited when their company or the division they head is to be bought by private equity. They have heard the rumors of independence from quarterly earnings and activist shareholders and the potential riches that are ahead of them when the company is sold. Other chief executive officers are cautious about the potential acquisition by private equity. They worry about a lack of public market for their stock, the intrusiveness of the private equity owners as opposed to a board of directors and loss of prestige heading a public company. Below we look at some of the topics a chief executive officer will focus on if his company is being sold to private equity.

A. **WILL YOU BE THE CEO?** Whether selling to private equity is good or bad is irrelevant if you are not going to be the chief executive officer (unless they want you in a lesser role and you are willing to accept it). It is often said (and true) that private equity bets on the chief executive officer of the portfolio company. They are selective of who they bet on, replace sitting chief executive officers and, especially in the case of divisions, bring in a new chief executive officer over existing management. Some of the signals that you need to be sensitive to are
---are they confirming to you that you will be the CEO or are they silent on future management
---are they eager to finalize your formal arrangements or are they putting it off
----do they have a consultant on the transaction that is acting like he or she expects to be the CEO or making all of the decisions
-----do they have portfolio companies that could be strategically merged with your company
-----are they discussing Chairman or board members capable of doing your job.

B. **HOW REALISTIC ARE YOUR PROJECTIONS.** While the private equity firm will do their own projections, both internal and for financing, they are likely to hold you to your own “sell” projections on designing your long term equity incentive plans and annual bonus. So, you need to be comfortable on being able to achieve them.

C. **PROJECTIONS OF POTENTIAL REWARD.** Most private equity firms provide a sheet or deck showing potential returns to management teams based on growth in EBITDA and sale multiples. They generally show that you are going to be very rich based on the assumptions. The questions that need to be asked are, how likely this is to happen? What is the $ pot versus the private equity return and as a % of the equity value created and how sensitive are these returns to variations in the assumptions?

There are a lot of assumptions that must all fall into place. Two of the most important being the EBITDA multiple and the EBITDA $. For the first there are many factors that go into the multiple, including market conditions so how much is the projected return based on projected expansion of the EBITDA multiple from what the private equity firm is buying in at? The other is the EBITDA at the time of sale, which in the model is usually based on your selling projections, but those usually assume a five year growth. However, If you are successful, many private equity firms will look to sell the Company earlier than your forecast plan. This means that the multiple will be applied to an interim EBITDA. If the performance vesting portion of the equity is based on goals incorporating the full projection over the five years, you may have a very successful company and exit for the private equity firm, but you may leave a significant portion of the projected equity return on the table.

D. **INVOLUNTARY EARLY TERMINATION.** The projections always show the chance of a very attractive reward upon exit, but what if you are terminated prior to the exit. The easy answer is that you will make far less than you expected from the projections. Most United States private equity portfolio company incentive plans are partially time based, e.g. 50% with 4 year graduated vesting, and 50% partially performance based. The performance-based equity is based on private equity cash on cash return multiples and therefore is generally forfeited if you are not there at exit, subject to certain protections on a termination shortly before the exit. The time based vesting is graduated. So, if you are terminated after 2 years, you would potentially receive 50% of the time based and no portion of the performance based. That is 20% of your expectation and, since the private equity firm is likely to call your interest upon departure, it is only of the 2 year growth. As most return profiles of PE investments are a J curve this can be particularly exaggerated. There are a lot of reasons why this is fair, but it needs to temper the expectations of large rewards. In European style deals, incentive vesting is usually fully time based over 4 or 5 years subject to a hurdle, but also subject to a call.

In addition to participating in incentive equity arrangements you will also be required to have “skin in the game” and rollover proceeds or invest alongside and on the same terms as the private equity firm. This is to assure that you have a downside as well as an upside. Many private equity firms treat this as a privilege and it can be and has been for many chief executive officers. However, it puts your economics, both your employment and much of your investment capital in many cases, in a very undiversified situation. The amount to be invested can be negotiated by you depending on your assets, other needs (such as housing, college, etc) and what you are receiving on the transaction, but the private equity firm will want it to be a significant economic commitment for you. In the United States, the investment is often subject to a call if employment terminates; in European deals, it usually continues as an investment until exit.

While it is unlikely you will be fired for cause, if you are, you generally will forfeit all incentives and only get back the lower of what you invested and fair market value on any rollover or investment. So long as cause is limited to egregious acts, there is probably little to worry about in these provisions, but some cause definitions are written broadly enough to cover performance. While you need to carefully review the definition, generally, if the company is not doing well, there is little value anyway.

E. VOLUNTARY EARLY TERMINATION. At some point you may want to leave the job before exit. Unless it is for Good Reason (i.e. constructive discharge), depending on the private equity firm involved and negotiations, you will either be subject to a call at fair market value or treated as a bad leaver and treated the same as if it was a termination for cause. While both will impact economic expectation, the former is obviously preferable.

F. DILUTION. Most Chief Executive Officers never focus on what happens to their equity interests if the company makes acquisitions and additional capital is invested by the private equity firm. The argument that you should be diluted since you will have a smaller piece of a bigger pie needs to be contrasted with the argument that, if the company had been the expanded size initially, you could have still received the same percentage of the company; so by doing post-closing acquisitions you are economically penalized. Therefore, some dilution protection needs to be considered if the original expectations are to be fulfilled. It is also important to consider the dilution impact to equity incentive from acquisitions alongside the issuance of new equity to incentivize incoming managers from these acquisitions.

G. POOL FOR MANAGEMENT. The incentive pool that is set up for management is allocated at closing except for a portion reserved for future hires and promotions. If someone leaves, their unvested portion is forfeited and their vested portion is generally called.
These portions of the pool generally go back into the pool unless and until reissued. But, if not otherwise dealt with prior to exit, the then unissued, as well as the lost value of the forfeited units, just reduce the outstanding capital in the company and increases the value for everyone and not just management. Therefore, unless you negotiated for an allocation of this value at exit to management, you will not receive the full value of the pool, although you and other individual managers will still receive the portion of the value of the company that was allocated to you and them.

Overal, Private equity has become an important economic force and most chief executive officers in their career will be tempted to join a private equity portfolio company even if their company is not sold to private equity. Like most things in life, there is good and bad. Your terms will be a “package” deal combing economic (risk and reward) with legal terms. The key is to be able to make an educated decision and not just listen to the myths—good or bad.

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