PE firms turn to management incentives to drive growth and unlock exit value

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Incentive plans form one part of a broader value-creation strategy. (Pexels Photo)

Summary

Management incentives, paid over and above the pay package, can be seen as profit sharing and help private equity (PE) funds attract and retain top talent to lead portfolio companies through to exit, industry executives said.
As private equity (PE) firms pursue larger control deals and consolidate through platforms, they are increasingly turning to structured management incentive programmes (MIPs) for portfolio company executives to align their interests with the investors' exit objectives.

These incentives, paid over and above the pay package, can be seen as profit sharing and help PE funds attract and retain top talent to lead portfolio companies through to exit, industry executives said.

Such exit-linked management incentive plans, or upside payment agreements that tie management payouts to the internal rate of return (IRR) or multiple on invested capital (MoIC) realized at exit, are becoming increasingly common as financial sponsors pursue more control and buyout deals in India, said Abhishek Guha, partner- corporate practice, Trilegal.

"These incentive mechanisms ensure that the management team stays motivated as they get to participate in the wealth creation when a financial sponsor achieves its preferred return benchmark," he added.

The creation of a platform refers to a strategy where a single PE-backed asset acquires other smaller businesses to expand operations, diversify offerings or enter new markets.

MIPs may assume even greater significance in platforms built by private equity funds, helping them attract high-quality senior executives to manage operations across acquired businesses and incentivize them to drive integration, expand scale and create value over the investment holding period.

Historically, several private equity firms, including Bain Capital, EQT, Carlyle, KKR, Warburg Pincus, Advent International, Blackstone, ChrysCapital and Samara Capital have pursued buyouts or built platforms, bringing in senior management talent to lead these businesses.

Some recent examples of private equity firms bringing in senior leadership to oversee their platforms include KKR-backed Healthium Medtech roping in Gaurav Goel as managing director and chief executive officer (MD & CEO), Warburg's appointment of Rehan Khan as CEO of Integrace Health, and ChrysCapital's appointment of Vikas Gupta as CEO and MD following the acquisition of Novartis India. EQT also brought in Parag Sharma to lead Zelestra's India operations last year while Samara along with a few other family offices backed Raajiv Singhal to manage and lead Marengo Asia Hospitals—its multispeciality hospital platform.

Broadly, these investors are placing greater emphasis on professional leadership, and the incentive plans have become central to that shift.

"What has changed is how systematic it has become. Our starting point is that management quality is one of most-cited drivers of deal success, and that acting too late on talent is a very common reason deals underperform," said Bettina Siempelkamp, EQT's head of Global Network Talent.

Incentive plans form one part of a broader value-creation strategy, with PE firms first setting performance goals for leadership teams and then structuring ownership plans to reward executives who deliver on those objectives, he explained.

These ownership plans help align newly-recruited senior executives with founders and investors by giving them a stake in the business and its eventual returns. They are structured around the investment holding period, and allow the management to realize value alongside the investors at exit, Siempelkamp said, adding that it is designed to keep executives focused on building a stronger business, including for its next owner.

Others such as Warburg and Samara emphasized on MIPs driving operational performance improvements through the life of an investment.

Samara, for instance, tailors its incentive plans to the complexity and duration of the transformation required at a business, as assessed during pre-investment due diligence, ensuring executives have a meaningful stake throughout the period needed to deliver results.

While incentives usually take the form of an employee stock option plan (Esop) programme linked to business performance, Samara also structures plans with incentives linked to the exit in some cases. "At times, leaders play an instrumental role in bringing a transaction together, and in such cases, we

offer them the opportunity to participate in equity from the beginning," said Vikram Agarwal, managing director and chief financial officer at Samara Capital.

Several factors, including the industry and the size of the business, determine the quantum of the incentive they receive. "Typically, the minimum hurdle we set is company performance being ahead of the industry's growth rate. This is supplemented by business-specific KPIs (key performance indicators), which inform the targets we set for management. Payouts are back-ended and typically linked to liquidity events," Agarwal added.

While these programmes play an important role in transitions from family-led to professionally managed businesses, "their relevance extends equally to professionally managed companies, where they help incentivize leadership teams to sustain growth, strengthen competitive performance and create long-term value," said Narendra Ostawal, managing director and head of India private equity, Warburg Pincus.

Lawyers involved in these transactions also noted that MIPs bridge the gap between fixed salaries and the potential upside for executives who grow the business and maximize value at exit.

"They're usually built as equity, ratchets or exit-linked bonuses, so the CEO and CXOs think like owners and get paid when the investor gets paid. The structure brings real tension, though. Rewards tied to the exit can push management towards short-term moves that look good at sale time, at the cost of long-term health," said Nidhi Killawala, partner at Khaitan & Co.

Such cases have prompted greater scrutiny and stronger governance, particularly at listed companies, where the Securities and Exchange Board of India (Sebi) requires prior board and shareholder approval for compensation arrangements between key managerial personnel and third parties, including PE investors. Getting the tax treatment, valuation, and exit clauses right is equally important, Killawala concluded.

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