

Private Equity Blueprints

A guide to granting equity to management
teams in PE-backed portfolios

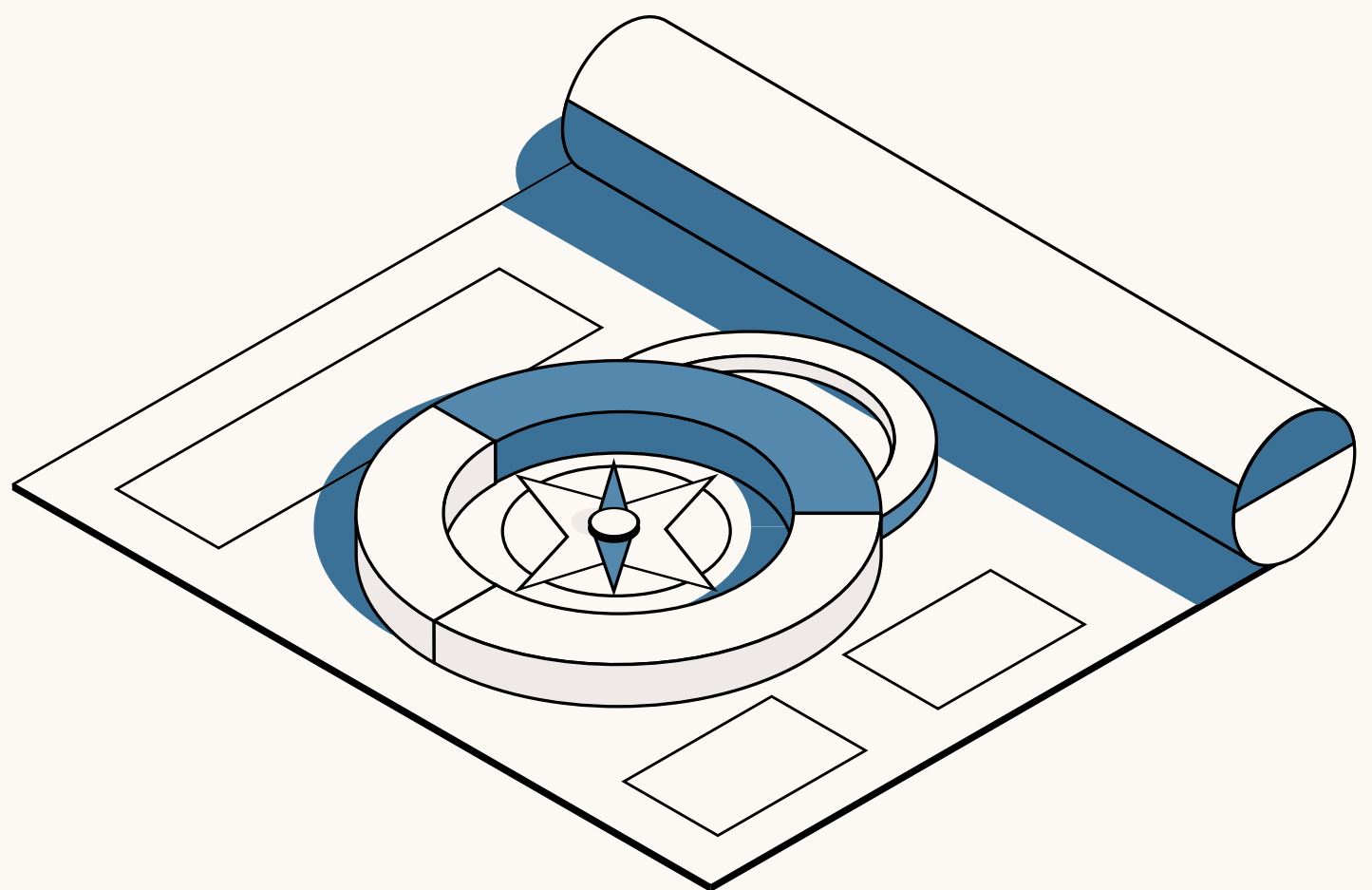


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In this guide, Carta provides a detailed overview of the equity types frequently used by private equity firms seeking to incentivize management and other employees.

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The purpose of management-incentive equity

Giving a true ownership stake to portfolio-company management is critical to aligning their interests with those of the PE sponsor(s) and building a foundation for growth.

There are several types of equity available to PE firms seeking to incentivize management of portfolio companies, and many ways to tailor them to firms' advantage. In this report we will cover several of the most typical equity types for PE firms in these situations.

Principal types of incentive equity

While there are a variety of equity incentives issued to portco management teams, the most common are stock options, options to acquire interests, profits interests, and phantom equity.

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Options (C-Corps)

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Phantom equity (Partnerships/LLCs)

Principal types of incentive equity

Here is a brief overview of each, followed by more-detailed descriptions of the advantages, disadvantages, and considerations:

Options (C-Corps)

Non-qualified stock options (NSO) and incentive stock options (ISO) are types of stock options most commonly utilized by corporations. When you grant options, you're giving the recipient the right to buy a set number of shares at a fixed price, also called the strike price. A company's 409A valuation or fair market value (FMV) determines the strike price of an option.

Options to acquire interests (Partnerships/LLCs)

Options to acquire interests are a similar concept to NSOs and ISOs but used by partnerships rather than corporations. Like corporate stock options, they give a recipient the option to become an equity-holder in the company when they choose to exercise their option.

Profits interests (Partnerships/LLCs)

Profits interest units (PIUs) are the most common form of LLC incentive equity. With PIUs, holders receive a percentage share of the proceeds upon the sale of the company, based on the increase in the company's value that occurred during the time they held the interest. Unlike options or other capital interests, there is no need to "buy" the units in order to receive the interest.

Phantom equity (Partnerships/LLCs)

Phantom equity is similar to a cash bonus when a company achieves a major milestone, including a share in annual profits, as well as proceeds from a sale. No actual ownership of membership interests is involved (hence the term "phantom").

1 Options

Options are a relatively simple and tax-advantageous form of equity for sponsors.

Advantages include their simplicity. The company grants the option, but then it's up to the holder to meet vesting requirements (if applicable) and exercise the vested equity at the appropriate time. This type of equity is typically issued to a broad range of employees, as well as non-employee stakeholders such as advisors, consultants, and other third parties.

Here is more detail on options:

Tax treatment

The company pays no tax on the granting of an option and receives a tax deduction equal to the spread between the strike price and fair market value at the time of exercise. For NSO holders, the spread is taxable as ordinary income. For ISO holders, instead of the spread being includable in ordinary income tax, it is included as income in the alternative minimum tax (AMT) calculation, which could trigger additional taxes owed when holders file their tax return.

Cashless exercise

When a holder chooses to exercise, they can either pay the strike price in cash or, if the company allows it, return a portion of their shares in a sale back to the company to cover the cost of exercise, referred to as a cashless exercise.

Withholding

The company will usually withhold ordinary income tax (which includes both payroll taxes and regular income taxes) on the spread when a holder exercises or may require the holder to pay the withholding tax out-of-pocket.

2 Options to acquire interests

With options to acquire interests, a sponsor (an LLC or or other partnership) grants the recipient a contractual right to buy a set number of capital interests (units) at a set exercise price, during a specified period of time. This type of equity is typically issued to employees at a company's early stages.

Upon purchasing the equity, recipients become actual equity owners and hold a capital interest in the company. As soon as holders decide to exercise and own the units, they are treated as partners/members of the issuer for tax purposes.

While options to acquire interests in LLCs operate similarly to corporate stock options, they have some important tax nuances.

Here is more detail on options to acquire interests:

Tax treatment

- In certain cases, the LLC is entitled to a tax deduction upon the exercise of an employee option because the transfer of equity interests to the employee is considered income.
- Employees can decide if they even want to pay the exercise price and become an equity holder (they don't have to). They also decide when they want to exercise (and therefore become a member of the LLC and start receiving K-1s instead of W2s).
- Upon purchasing the equity, LLC holders become actual equity owners and hold a capital interest in the company, so the holder has an economic right in the preexisting value of the LLC. As soon as holders decide to exercise and own the units, they are treated as partners/members of the issuer for tax purposes.

Conditions required to exercise

From an employee perspective, options to acquire units are not an ideal asset to hold while still employed at an LLC, since they require the holder to become a partner but without the tax advantages of other forms of equity.

For that reason, companies that offer options to acquire units typically make them exercisable if one of three conditions are met:

- The employee terminates their employment
- The LLC converts to a C-corp
- The company undergoes a change of control.

The administrative burden

Options to acquire interests come with some administrative burden for the sponsor.

Granting options to acquire interests to multiple employees means the company must keep track of multiple dates of exercise, even if all options were granted on the same date, because recipients can choose when or whether to exercise their options. Since each exercise must be accompanied by the company's updated Fair Market Value, this plan's administration can become burdensome.

If options to acquire interests can be exercised prior to a termination of employment, companies have to be able to address the human resources, finance, payroll, and legal issues of having an employee convert to non-employee status. To minimize this burden, as mentioned, companies often restrict exercise to after the termination of employment, conversion to a C-corp or other entity structure, or sale of the company.

See [LLC Equity Blueprints](#) for more information on options to acquire interests and other forms of LLC equity.

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Profits interests

Profits interest units (PIUs) are the most common form of LLC incentive equity. Upon a sale of the company, PIU holders—who are considered members or partners—receive a percentage share of the proceeds, based on the increase in the company’s value that occurred during the time they held the PIUs. This type of equity is typically issued to mid-to-upper-level management.

The PE sponsor can structure the profits interest plan to allow participants a variety of rights, including transferability, vesting, and annual participation in distributions (if any). It can also include forfeiture on departure from the company.

For existing members or partners of a partnership, one benefit of PIUs is that existing/prior owners retain their share, because a threshold value for the company is set at the time of any new profits interest grant, and recipients receive only a percentage share of future profits (not past equity).

An example

1. XYZ LLC offered a profits interest plan to its employees on July 1, 2023. As of that day, its fair market value is \$1M. That means recipients will only be paid out on money collected in the sale of the company over and above \$1M.
2. Eve Employee is granted 1% of XYZ LLC as a profits interest, which will vest over 4 years.
3. The company is sold on July 1, 2028, for \$5M.
4. Eve Employee will be paid 1% of \$4M or \$40,000 since she does not participate in the first \$1M of the sale as that was the threshold value associated with her profits interest.

*simplified scenario; does not include potential dilution by other shareholders

Here is more detail on profits interests:

Tax treatment

There are no particular tax benefits for a company issuing PIUs—there is no tax deduction, either at the time of the grant or in the event of liquidity. However, at the time of exit or other distribution on the PIUs, the PIU holder’s share of proceeds is directly taxable to that holder, thus providing an “effective” tax deduction to the other members.

Distribution thresholds (“hurdles”)

Newly granted profits interests must have a distribution threshold or “hurdle amount” so that the appreciation over and above that hurdle can be calculated for interests holders upon a triggering event such as a sale of the company. This ensures that holders benefit from the increase during the time they held the interests but not from the previously existing enterprise value.

Catch-up provisions

In some situations—for example when seeking to make a better equity offer to prospective key hires—companies may choose to grant profits interests with a “catch-up” provision, in which the grant is structured so that the recipient can participate not only in the future growth of the company above the threshold value, but can also participate in the existing enterprise value of the company—essentially, to enable that holder to “catch up” to existing shareholders. This is accomplished by allocating profits that would otherwise be allocated to the existing members to the capital account of the holder.

3 Profits interests (continued)

Separate holding companies

Employers may also structure a profits interest to be held in a separate holding company to maintain a recipient's employee status and minimize tax impacts that may result from becoming a partner.

Administrative burdens

A profit interest plan requires more administrative work than other LLC equity types, such as phantom equity or options to acquire units.

Multiple PIUs to track

As a company grants equity over time, there will be multiple equity holders, who may have different Fair Market Value or "threshold" amounts tied to their equity grants. All of this must be accurately tracked, so that cash distributions and liquidity events are handled correctly and everyone is rewarded properly according to their equity. (Carta offers a [full platform](#) to handle LLC equity management.)

Company governance requirements

New partners or members must be admitted to the LLC in accordance with the LLC's governing documents. This requires legal paperwork and accurate record-keeping.

Regular valuations required

The company will need to establish valuations regularly. You don't need to conduct one every time a new grant is issued, but they should be conducted fairly regularly, typically annually or following any material events that may impact company value.

Reporting requirements

The company must make annual reports and provide disclosures to stakeholders, depending on the information-sharing rights provided.

Preparation of tax documents

The company must prepare [Schedule K-1](#) forms for each partner—a tax document that breaks down each LLC partner's share of the partnership's income, losses, deductions, and credits for a given tax year. As a pass-through entity, the LLC is not taxed directly—taxes are passed through to partners.

4

Phantom equity

Phantom equity enables the employee-recipient to receive a cash payout or share of annual profits when the company achieves a major milestone, such as being acquired. This type of equity is typically issued to a broad range of employees due to the ease of rollout.

Sponsors can choose a wide range of goals to trigger phantom equity distributions—for example, an acquisition, or hitting certain revenue or profit metrics. Phantom equity awards may, but are not required to be, an “appreciation only” award like a profits interest.

Phantom equity is relatively easy for sponsors to administer, and can incentivize employees to contribute to company successes. From an employee perspective, it does not represent actual equity in the company.

Here is more detail on phantom equity:

Recipient retains employee status

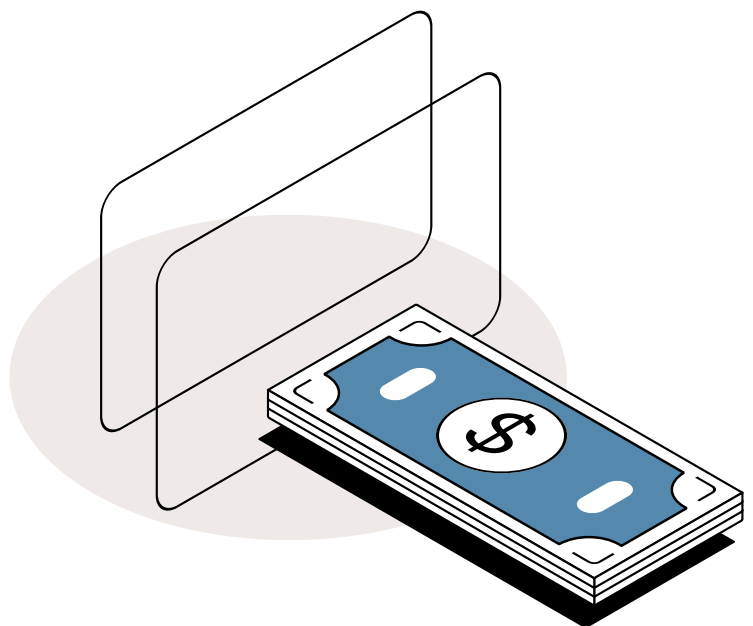
This means employees continue to receive company benefits and W-2 tax forms, and their employer can continue to withhold taxes from their regular cash compensation, as they do not hold an equity stake and do not become members or partners.

Ease of administration

Phantom equity generally requires few, if any, changes to the LLC’s operating agreement. If awards are designed as full value awards, there’s no need to track threshold values at the time of the grant or calculate the spread between the threshold value and the company value at the time of exit.

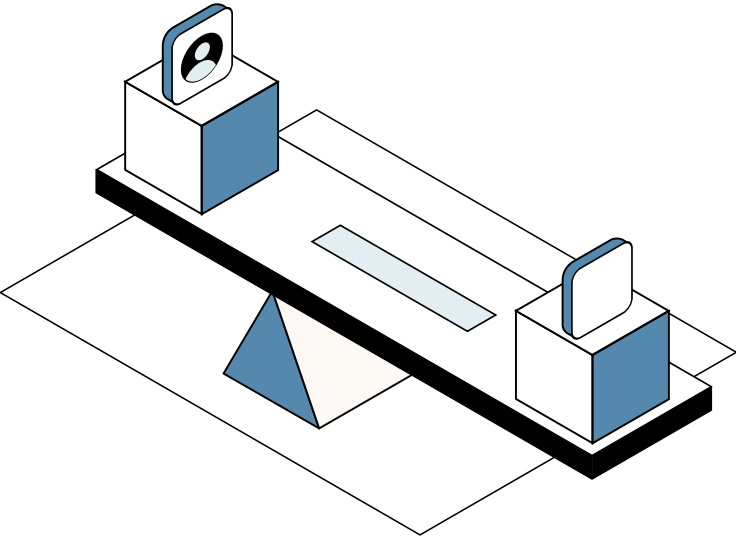
Termination

Participants in phantom equity plans are generally required to remain employed with an LLC to benefit from any payouts.



Comparing the equity types

Highlight	Options	Options to acquire interests	Profits interest units (PIUs)	Phantom Equity
Incentives aligned between company, employees	✓	✓	✓	✓
Free for employees to acquire			✓	✓
Holder’s upside can also include share of future appreciation of the business	✓	✓	✓	✓
Holder’s upside can also include share of existing company value	✓			✓
Payout protection for existing members on current value of LLC			✓	✓
Employees can retain employment status	✓	✓		✓



Other considerations

Vesting / Repurchase rights

When management from a target company in an M&A transaction is granted incentive equity, eventual payout of the equity is typically conditioned on the equity recipient remaining with the company (or, said differently, the equity incentivizes the holder to stay at the company). Equity grants generally include vesting provisions which require the service provider to remain with the company in order to earn the equity award. If the equity holder leaves the company for any reason, the PE firm will have the right to repurchase any unvested equity from the holder.

Management equity rollovers

In an M&A transaction, management at the target company that will remain with the new enterprise is typically given the option to transfer (“rollover”) part of their sale proceeds into equity in the new enterprise. The willingness of management to do so is seen as a positive by the PE firm, as it aligns incentives between the firm and management that is remaining with the enterprise post-closing. These arrangements may be contemplated and implemented as part of the acquisition transaction itself.

In addition to being a positive gesture of alignment, equity rollovers can also result in economic benefits for the target company’s management staying with the enterprise post-sale. This can be especially significant in cases in which the sale price was less than the target company hoped for.

Potential advantages of management equity rollovers for recipients:

- Use of leverage by PE firms in the acquisition of the target company can serve to increase the rollover participant’s stakes in the new enterprise.
- PE firms may be willing to work with rollover participants to structure the rollover on a tax-deferred basis.
- Appreciation of fully vested stock rolled over by management at fair market value is subject to capital gains tax rates rather than ordinary income rates.

Waterfalls

The type of equity granted to employees and management of private companies, whether they are C-corps, LLCs, or other partnerships, has implications beyond the alignment of incentives between sponsor and recipient. The decision of which equity program to administer will also affect the distribution of profits once the portfolio company experiences a liquidation event, such as a merger, acquisition, or initial public offering.

Waterfalls or waterfall modeling is a term used colloquially to describe the financial modeling used by companies and their investors to determine how proceeds will be distributed after a liquidity event. Waterfall refers to how the proceeds cascade from more preferential equity holders to the common equity holders. Most LLC operating agreements—or certificates of incorporation for c-corporations—define a clear pecking order for how different types of unitholders will be paid out in the event of an exit. This payout structure is called waterfall analysis or an exit waterfall, because of how distributions spill over from one class of unitholder to the next, moving down the cap table.

Venture capital and private equity investment firms, as well as the law firms that represent them, typically build waterfall models to predict the value of their holdings across various portfolio companies based on a number of variables, such as the unit classes' preferential rights, the timing of the exit, and the predicted valuation. Upon a liquidity event (also called an exit event), depending on the company's valuation and liquidation structure, some equityholders may receive a larger return than others; some may receive no return at all.

The complexity of a particular waterfall model depends on a number of factors, but is strongly related to the complexity of a company's cap table.

Simple waterfall modeling

The waterfall for a company with a simple cap table can be thought of as a fraction. The numerator represents the exit value of the company after repayment of debt and other obligations (i.e. the equity value), while the denominator represents the number of outstanding units.

$$\frac{\text{Exit value} - \text{Debt}}{\text{Number of outstanding units}}$$

Generally speaking, a simple cap table for an LLC would have no profits interest units (PIU) with a liquidation threshold greater than \$0, no required return of capital contributions, and no other non-standard liquidation rights and preferences.

For example, if we assume there were only 12 million ordinary units—or shares of common stock for c-corporations—on the cap table and the equity value upon an exit were \$1.5 billion, then the entire waterfall analysis would be \$1.5 billion divided by 12 million ordinary units, resulting in a payout of \$125 per unit.

$$\frac{\$1.5\text{B}}{12\text{M units}} = \$125$$

Of course, most waterfall modeling is not this simple.

For a detailed deep-dive on Waterfall modeling including scenarios of increasing complexity, [click here to download Carta's Waterfall 101 Whitepaper](#).



Carta for Private Equity

Learn how Carta supports PE firms and PE-backed companies

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