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Deloitte
Valuation
Conference

Valuation for
Incentive Plans

October 2015



Introduction

Facilitators



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Conference Agenda



2015 Valuation Conference Series

1. Valuation for AIFMs

10 February 2015

2. AIFMD valuation requirements for depository banks & asset servicers

24 February 2015

3. Fund directors: valuation and related risks

12 March 2015

4. Valuation matters for conducting officers and risk managers

23 April 2015

5. Fair Value requirements under IFRS 10 and 13

21 May 2015

6. Sound valuation in credit institutions: more than a regulatory requirement

16 June 2015

7. Valuations for incentive plans

15 October 2015

8. Valuation and Tax considerations

12 November 2015

9. Valuation: How to meet audit requirements

8 December 2015

If you have any questions or comments, please contact valuation@deloitte.lu

Content

1. Regulations

2. Taxes

3. Waterfall Economics

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Remuneration Principles

What to whom?



Banks

- 2013/36/EU (CRD IV)
- CSSF 10/496 (CRD III)
- CSSF 11/505 (PP)
- CSSF 14/594 (DR)
- CSSF 15/601 (notification of increased 1:1 ratio)

Specialized Investment Firms

- CSSF 10/437, however, the CSSF is under no obligation to monitor and/or control its effective implementation

Investment Firms (PSF)

- CSSF 10/437
- CSSF 10/497 (CRD III)
- CSSF 11/505 (PP)
- CSSF 14/594 (DR)
- CSSF 15/601 (notification of increased 1:1 ratio)

CSSF 14/585 (MiFID) is applicable to all those providing investment services of individual portfolio management or non-core services

AIFMs

- 2011/61/EU
- ESMA 2013/232

OPCVM

- 2009/65/EU (UCITC IV)
- 2014/91/EU (UCITS V)

Support Investment Firms

No obligation to conform to specific remuneration policies and procedures

Remuneration Principles

Overview



Objectives

Risk alignment and avoid excessive risk taking

Scope

Remuneration in its broadest meaning

All staff



General requirements

Governance
Transparency
Risk management

«Identified Staff»

Material impact
On risk profile



Specific requirements

Proportionality principle

Remuneration Principles

General requirements – All staff



1

Guaranteed bonuses should be exceptional, must only occur when hiring new staff and be limited to the first year

2

Severance payments must not reward failure

3

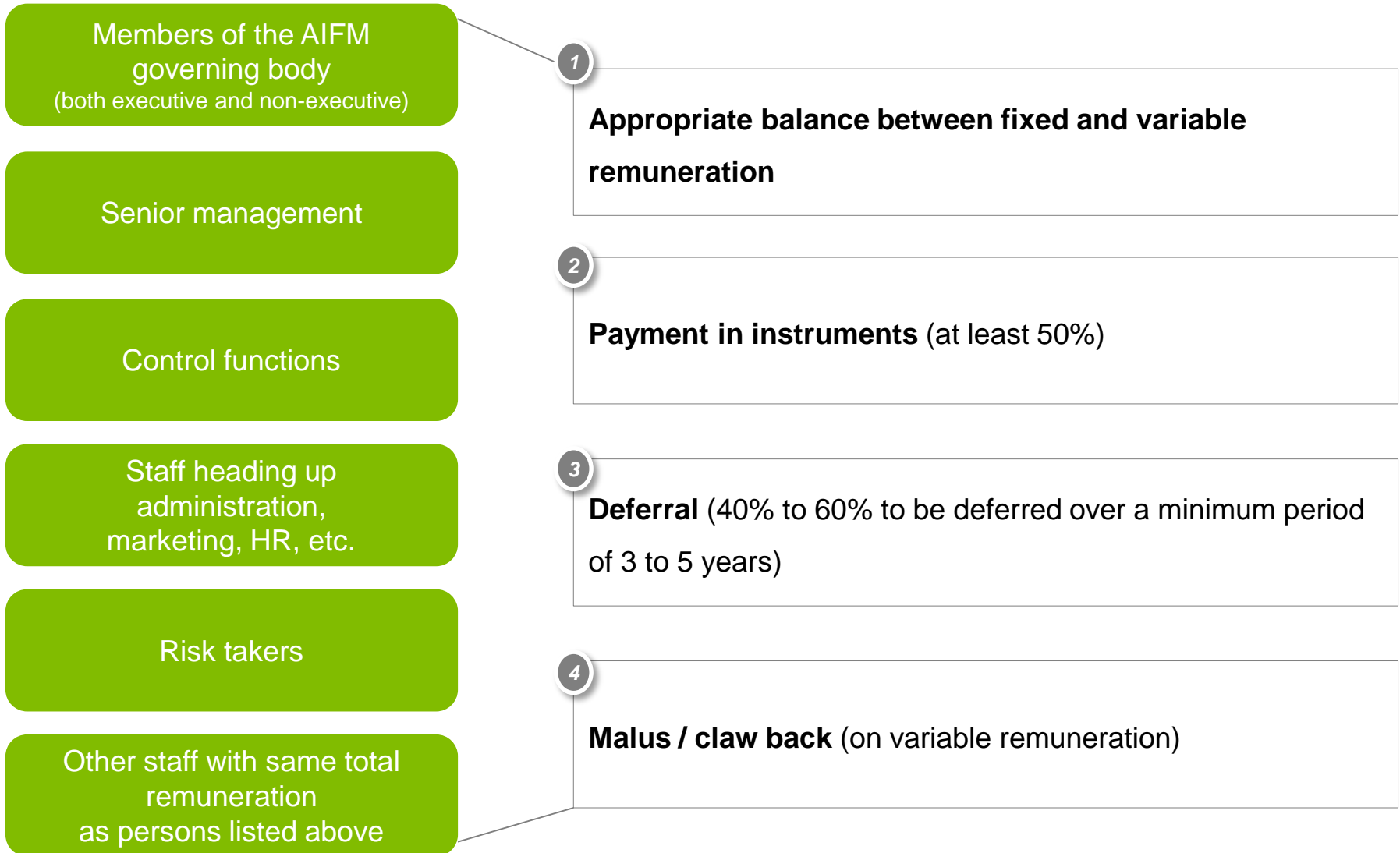
Employees must undertake not to use personal hedging strategies

4

Discretionary pension benefits must be paid in instruments and be subject to a retention period of at least five years

Remuneration Principles

Specific requirements – Identified Staff



Remuneration Principles

Identified Staff – Payout process - Example

| EUR 100,000 | 2015 | 2016 | 2017 | 2018 | 2019 |
|----------------------|--------|--------|--------|--------|------|
| Cash (20%) | 20,000 | | | | |
| Instruments (20%) | 20,000 | | | | |
| Cash (30%) | | 10,000 | 10,000 | 10,000 | |
| Instruments (30%) | | 10,000 | 10,000 | 10,000 | |

Malus / claw back

Remuneration Principles

Governance



Remuneration policy

- Establish a remuneration policy
- Shall be reviewed at least annually and updated when necessary

Supervisory function

- Shall rely on controls performed internally
- Carried out by relevant persons or bodies, in order to avoid conflict of interest
- Could be performed by the management body depending on the AIFM's size

Remuneration Committee

- Composed of non-executive members of the management body
- For entities which are part of greater groups, they might rely on the groups RemCo



Remuneration Principles

Disclosures

External

Total fixed and variable remuneration paid to all staff

Aggregated remuneration for identified staff

Details of remuneration policy and processes, including governance

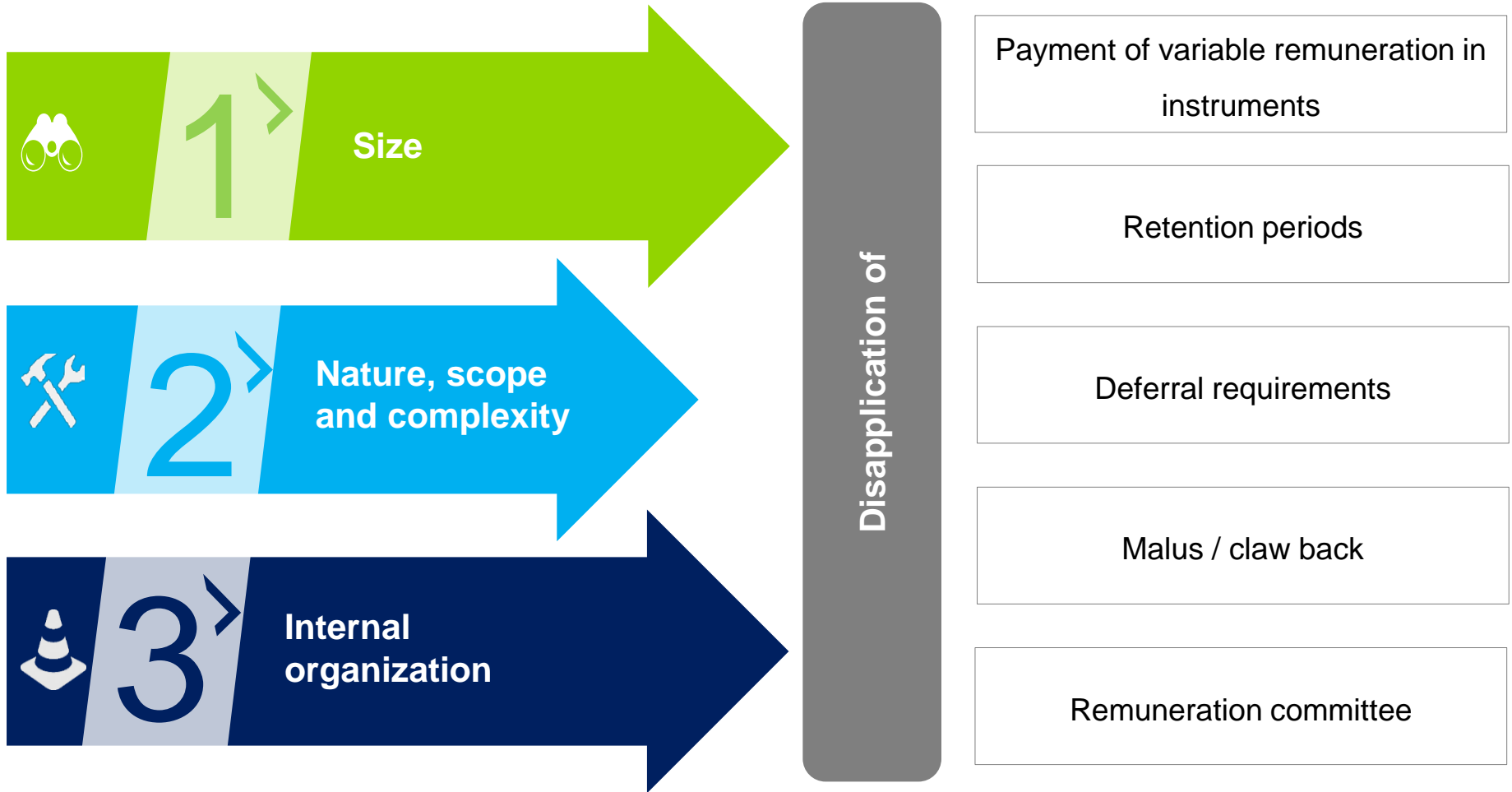
Internal

Remuneration policy available to all staff



Remuneration Principles

Proportionality



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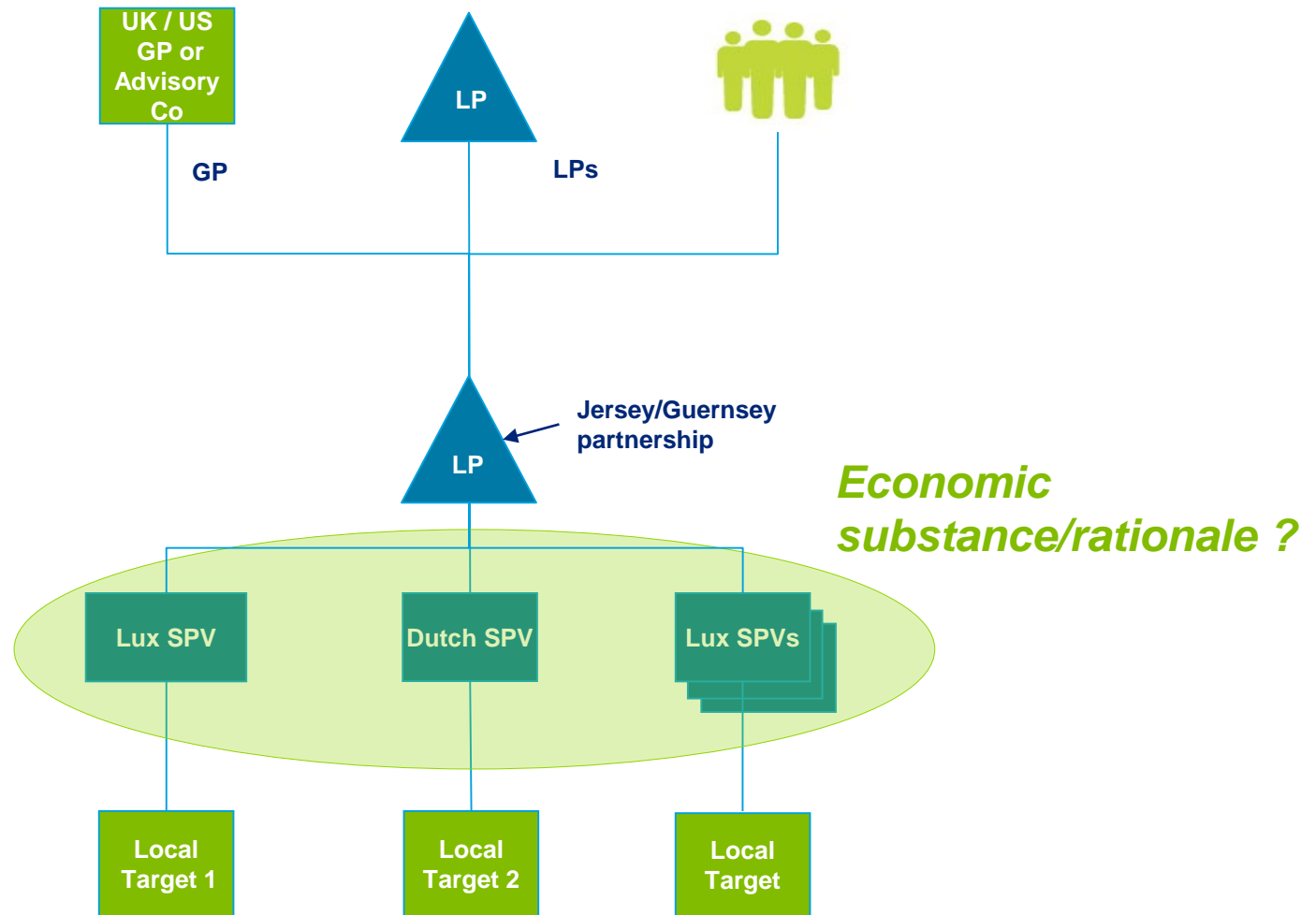
3. Waterfall Economics

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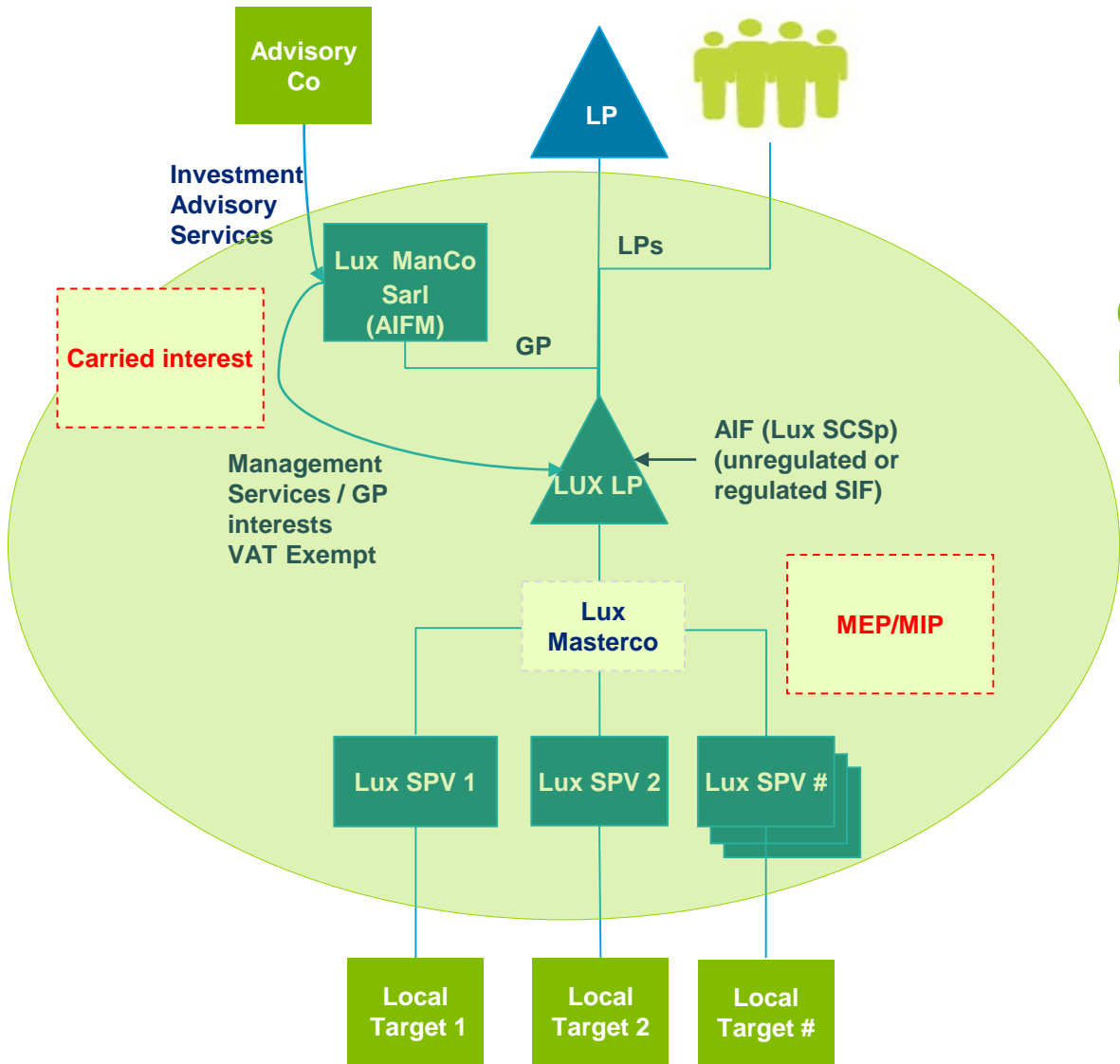
Acquisition structure

Example of structure



Acquisition structure

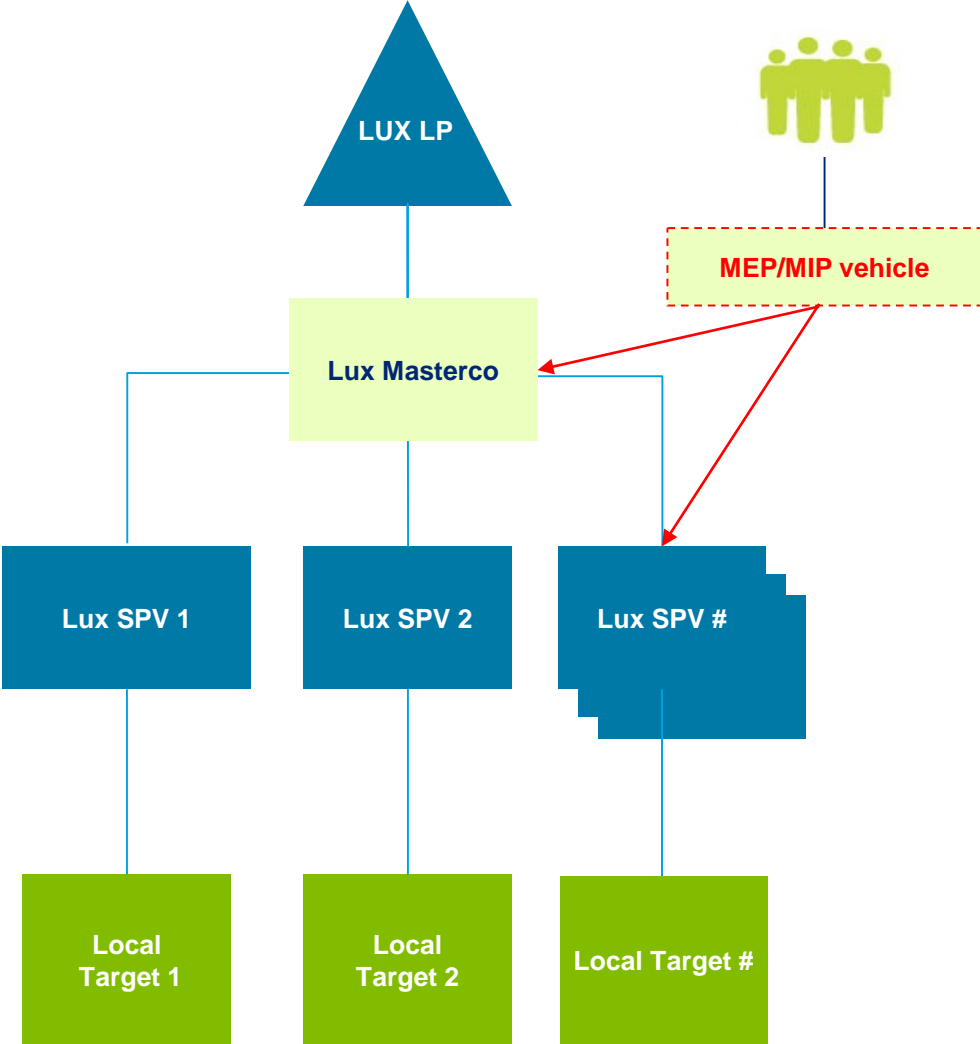
Set up of a business platform



Conduct of business in Luxembourg

Acquisition structure

MEP/MIP

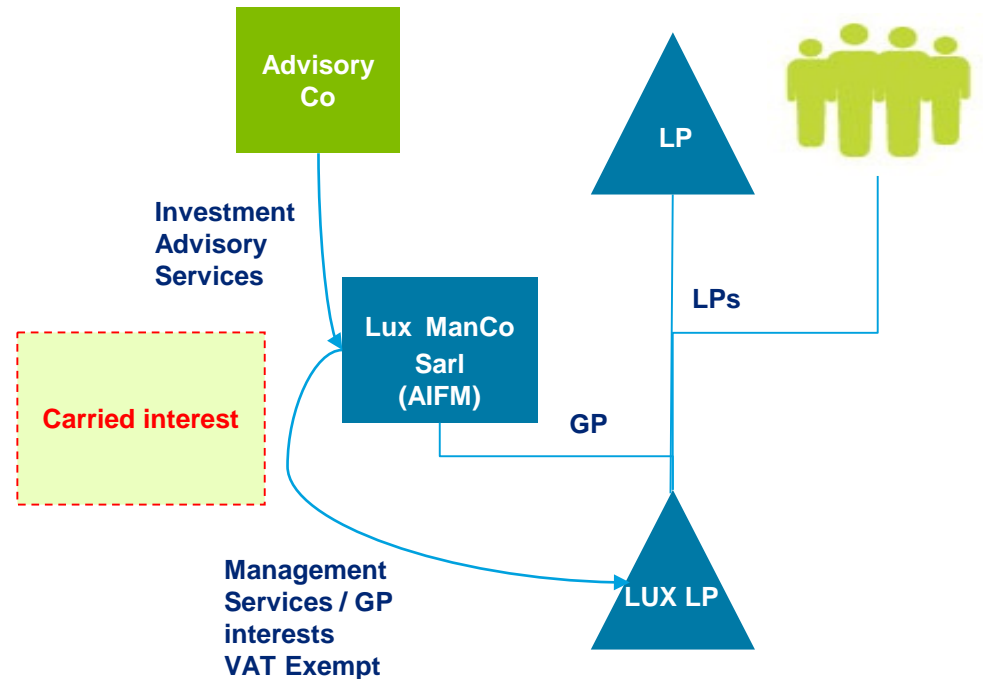
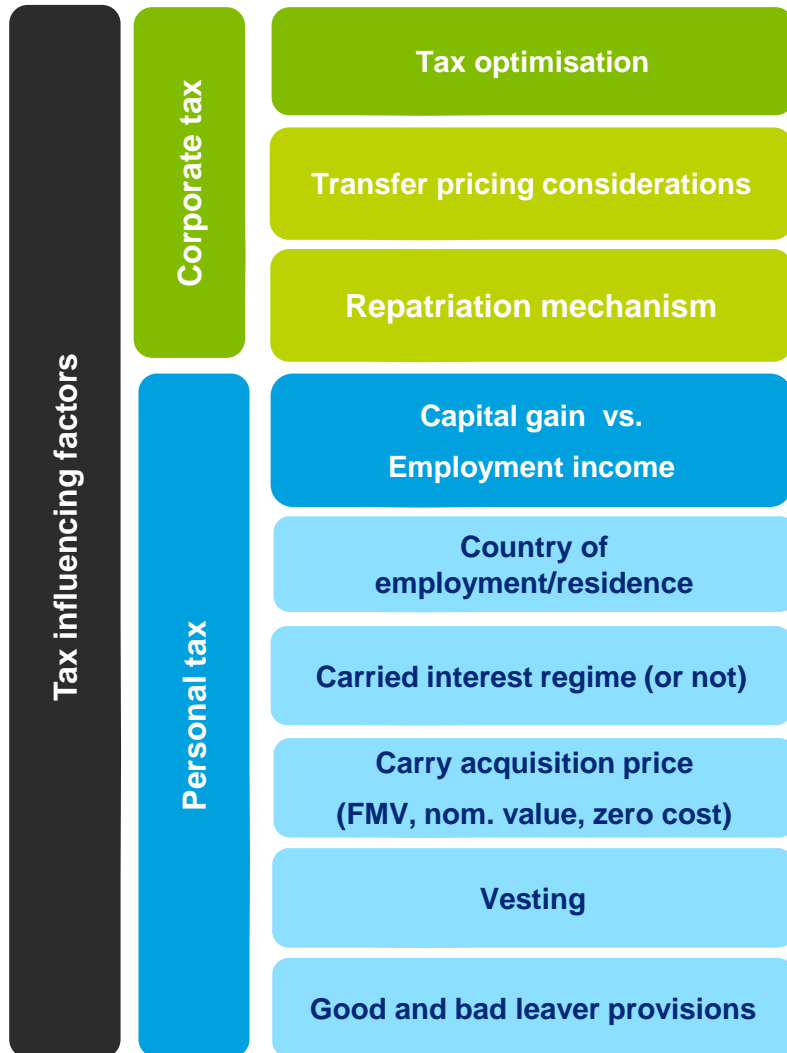


Tax influencing factors

- | | |
|---------------|--|
| Corporate tax | Tax optimisation |
| | Location of pooling vehicle |
| | Repatriation mechanism |
| Personal tax | Capital gain vs. Employment income |
| | Country of employment/residence |
| | Legal form of the award (shares, options, etc.) |
| | Award acquisition price (FMV, nom. value, zero cost) |
| | Vesting |
| | Good and bad leaver provisions |

Acquisition structure

Carried interest



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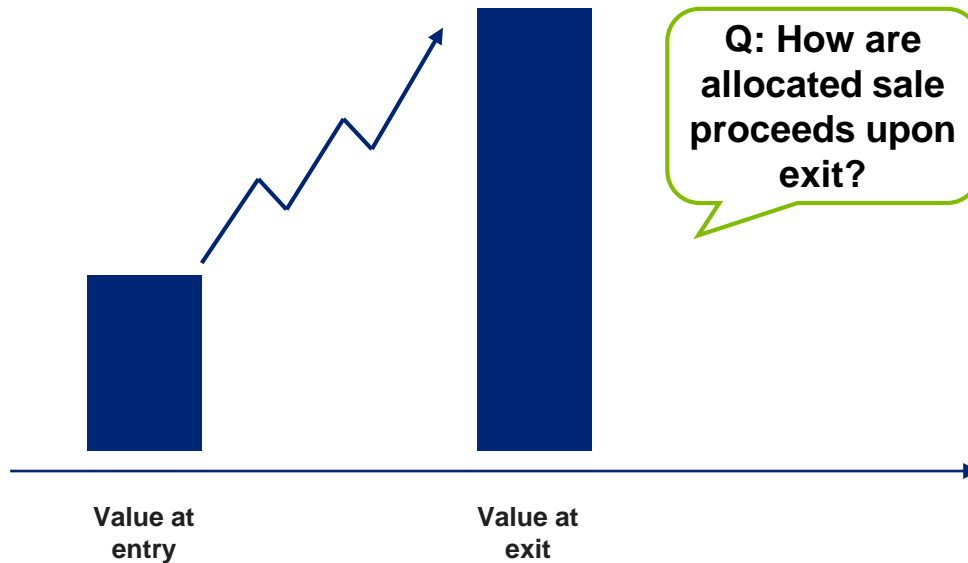
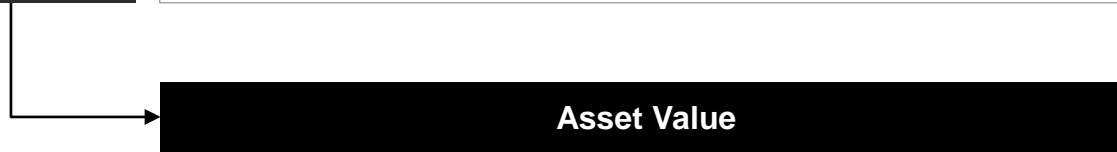
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Waterfall economics

Overview

| | |
|--------------|---|
| WHAT? | PE/RE investments |
| WHY? | Allocation of sale proceeds / value created |
| HOW? | Waterfall |



What's next?

- Waterfall main features
- Other components



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3. Waterfall Economics

3.1. Waterfall main features

3.2. Other components

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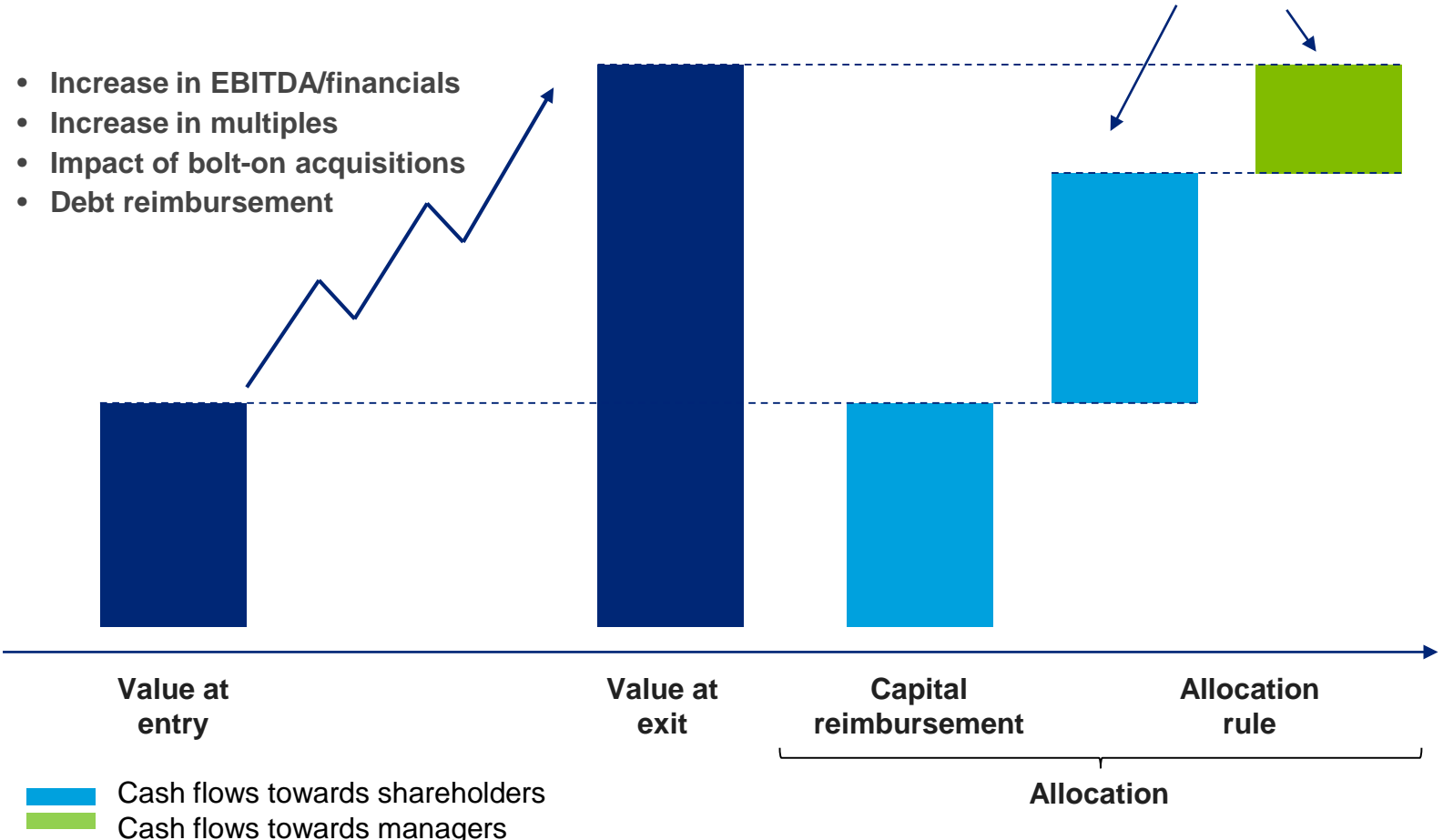
Waterfall economics

3.1. Main features

Simple target allocation principles...

- Increase in EBITDA/financials
- Increase in multiples
- Impact of bolt-on acquisitions
- Debt reimbursement

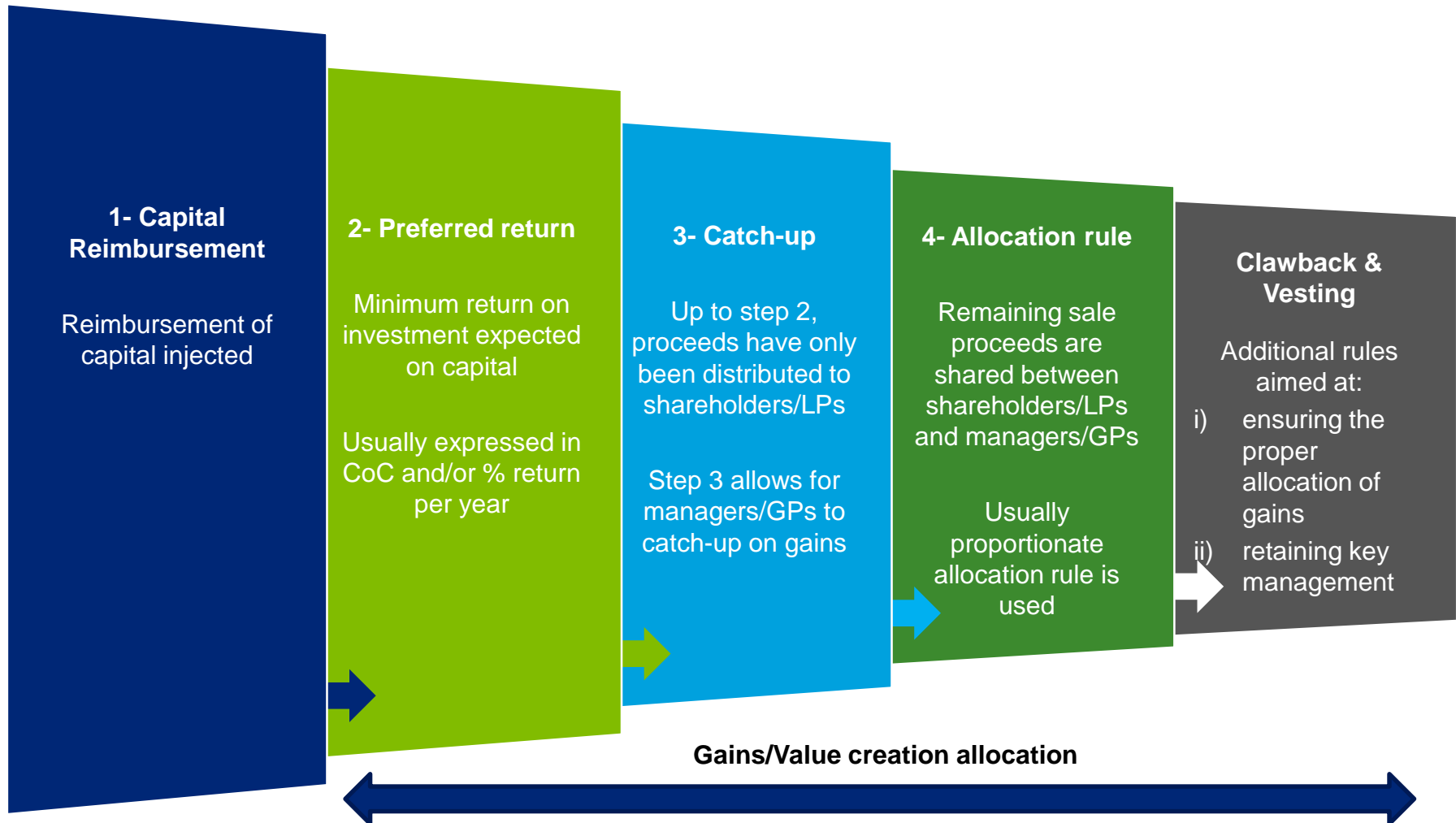
Target allocation results from negotiation between shareholders and managers:
e.g. 80%/20%



Waterfall economics

3.1. Main features

...Slightly more complicated in practice



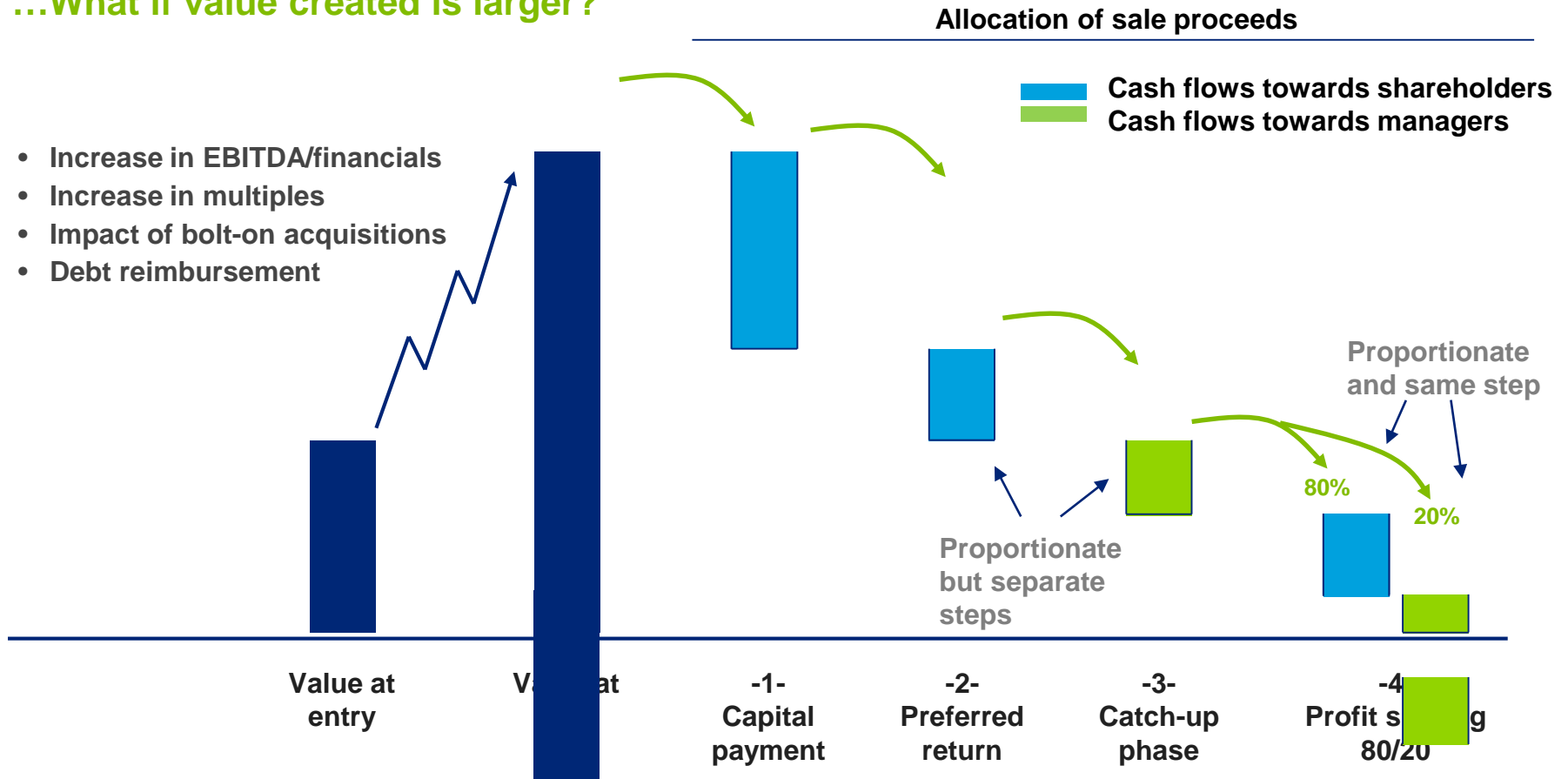
Waterfall economics

3.1. Main features

How sale proceeds are allocated?

...What if value created is larger?

- Increase in EBITDA/financials
- Increase in multiples
- Impact of bolt-on acquisitions
- Debt reimbursement



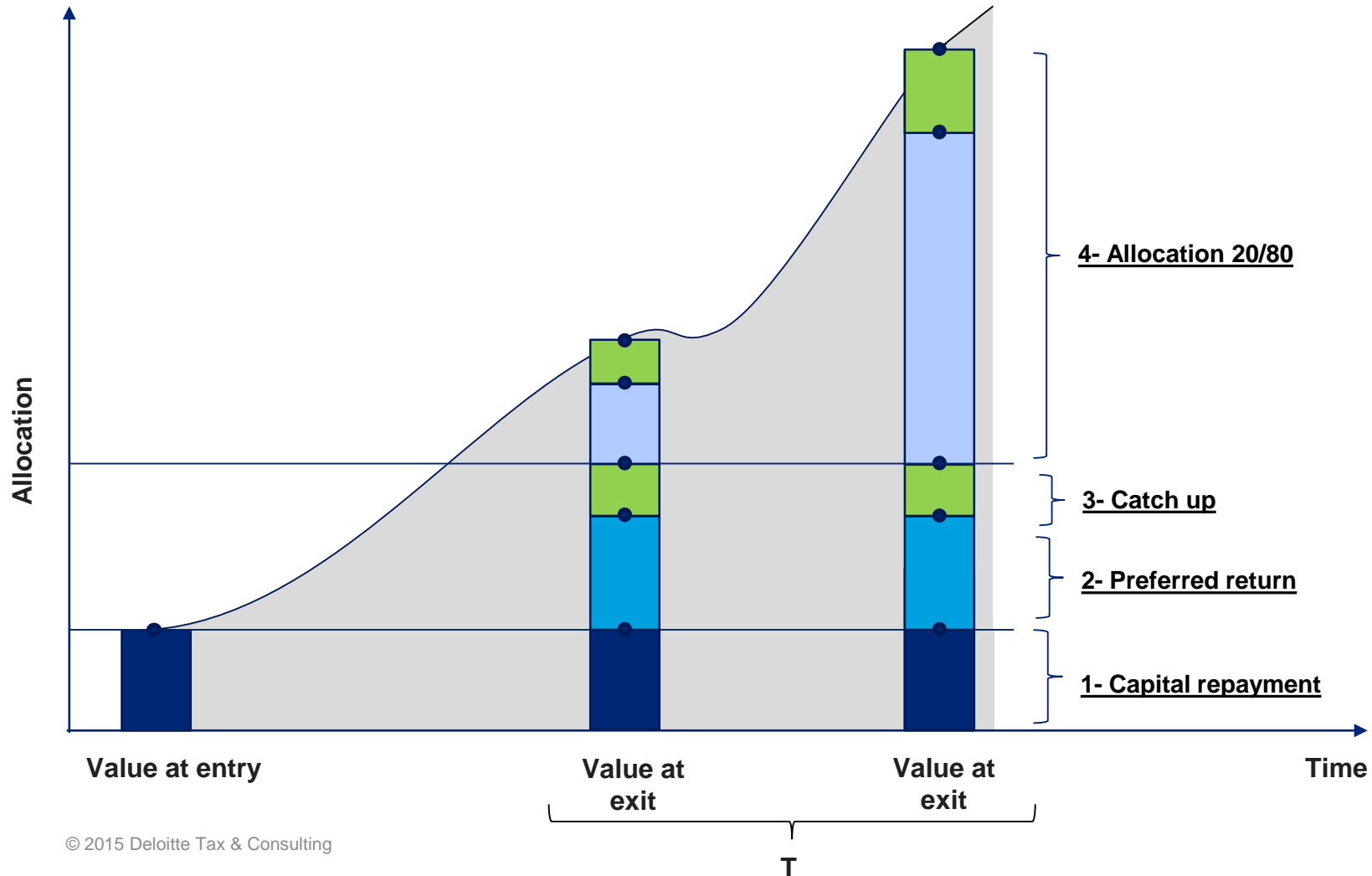
Waterfall economics

3.1. Main features

How sale proceeds are allocated?

... Impact of a change in sale proceeds

■ Cash flows towards shareholders
■ Cash flows towards managers



Waterfall economics

3.1. Main features

How sale proceeds are allocated?

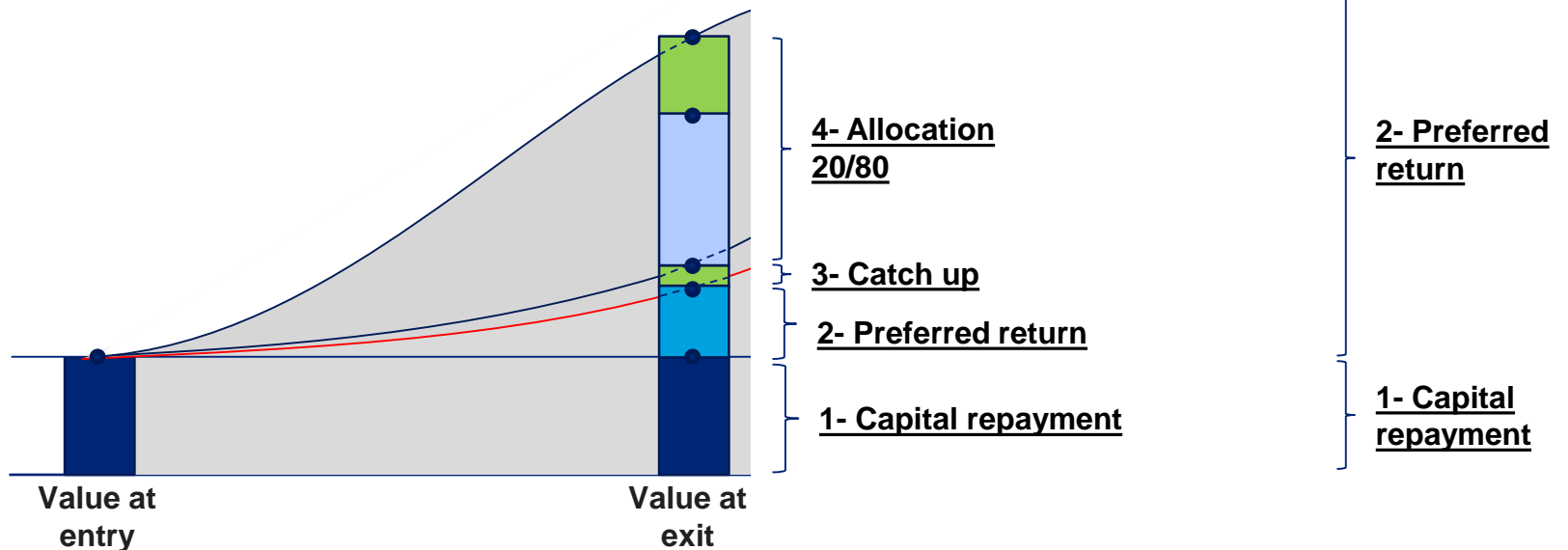
... Impact of a change in exit date

■ ■ ■ Cash flows towards shareholders
■ ■ ■ Cash flows towards managers

Allocation of sale proceeds

Despite waterfall occurs only once, upon exit...

... allocation of value is dynamic as preferred returns are time dependant



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3.1. Waterfall main features

3.2. Other components

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Waterfall economics

3.1. Other components

Vesting

Right to share gains is progressively acquired over time, e.g. 20% of the plan vests at each anniversary of the grant date

Good leaver

Any person who leaves the company because of retirement, disability, death, is dismissed for economic reasons, etc.

Bad leaver

Any person who resigns, is dismissed (for gross misconduct), etc.

Claw back

Participants might be obliged to reimburse (part of) their payments upon occurrence of predefined events (e.g. claims from third parties, etc.)

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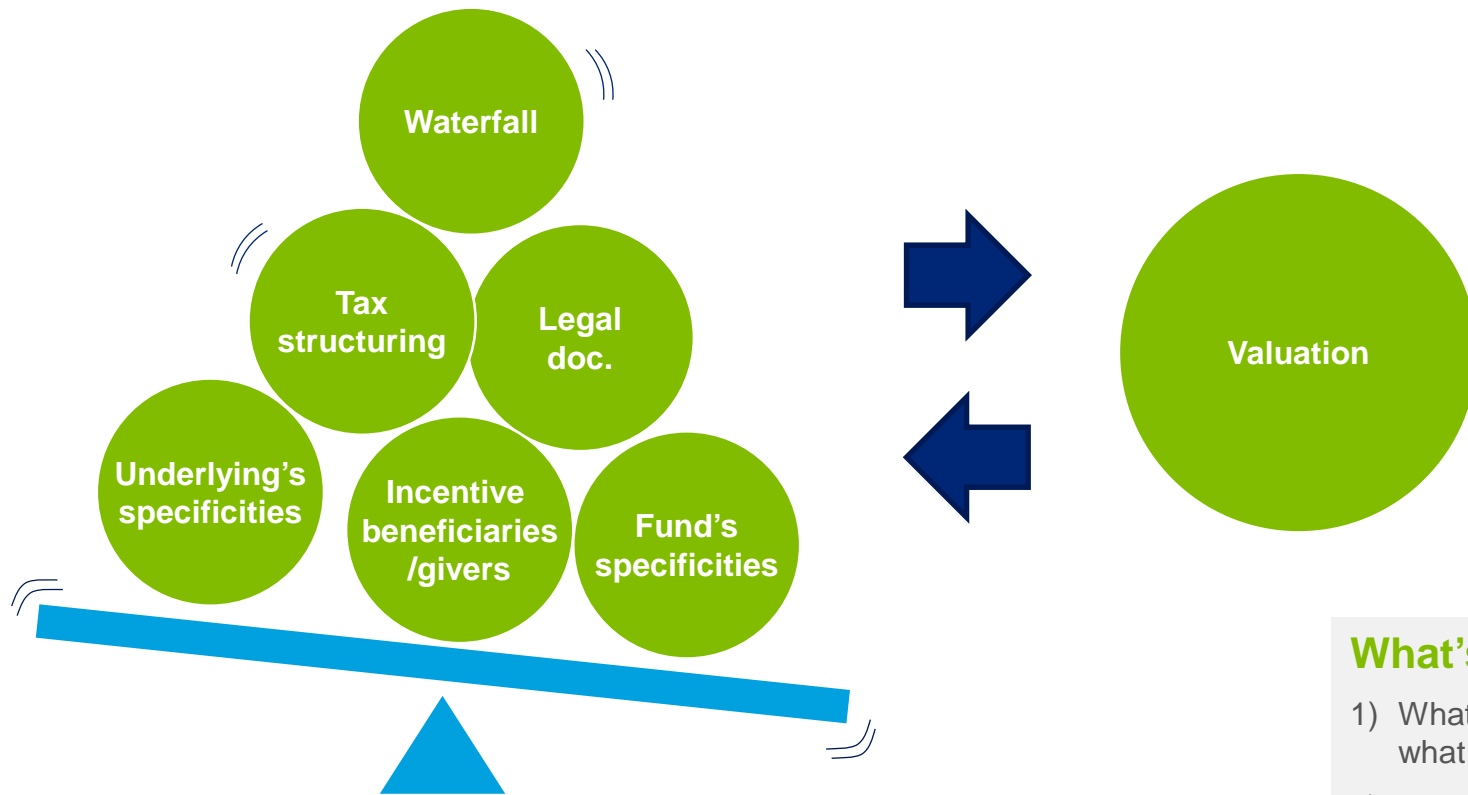
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Valuation

Introduction



Equilibrium

Structuring an incentive plan results in finding the right equilibrium through discussions with many different parties

What's next?

- 1) What is an option and what drives its value?
- 2) Find the appropriate valuation methodology?
- 3) Valuation process

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4.1. What is an option and what drives its value?

4.2. Find the appropriate valuation methodology?

4.3. Valuation process

5. Conclusion

Valuation

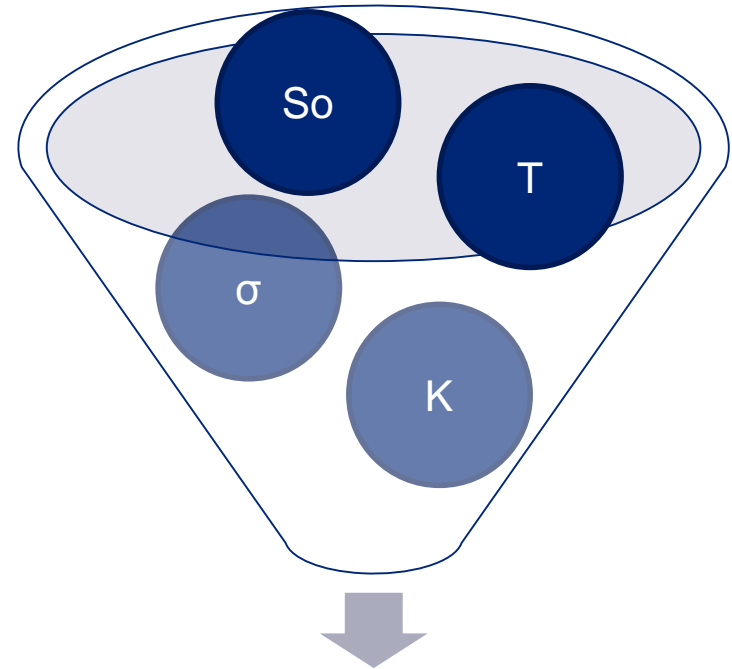
4.1. What is an option and what drives its value?

Definition

“Options are contracts through which a seller gives a buyer the right, but not the obligation, to buy or sell a specified number of shares at a predetermined price within a set time period.”

Source: Nasdaq

Parameters



Option to purchase/sell a stock at price K at time T knowing that:

- current stock price is S_0
- volatility of the stock is σ

Valuation

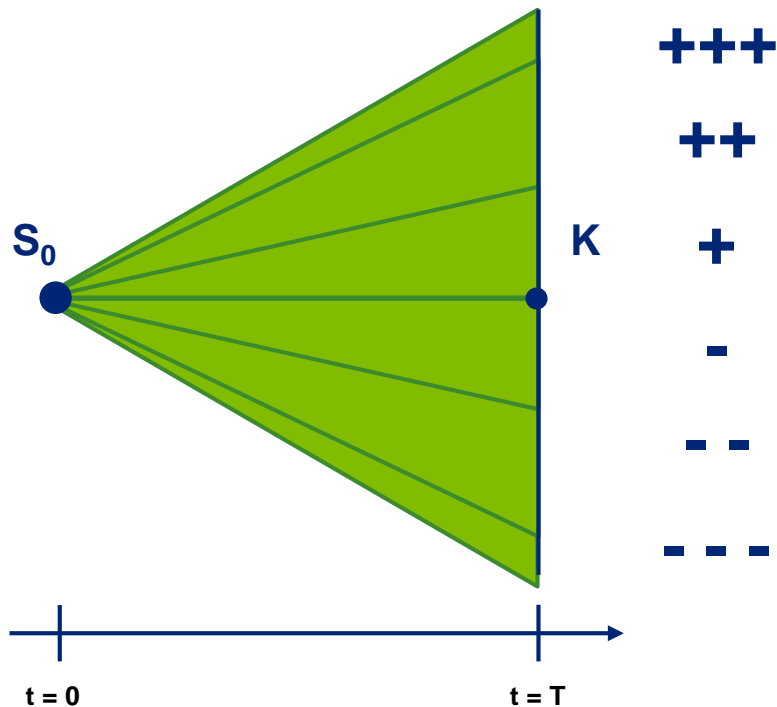


4.1. What is an option and what drives its value?

Volatility

Let's consider...

A call, i.e. right to purchase at price K with $K=S_0$



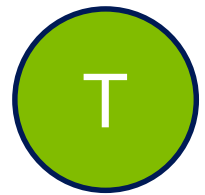
Volatility is a measure of dispersion

The more volatility, the more dispersed will be the future price of a stock

An option has always a positive value

Therefore as volatility increases, so does the option value

Valuation

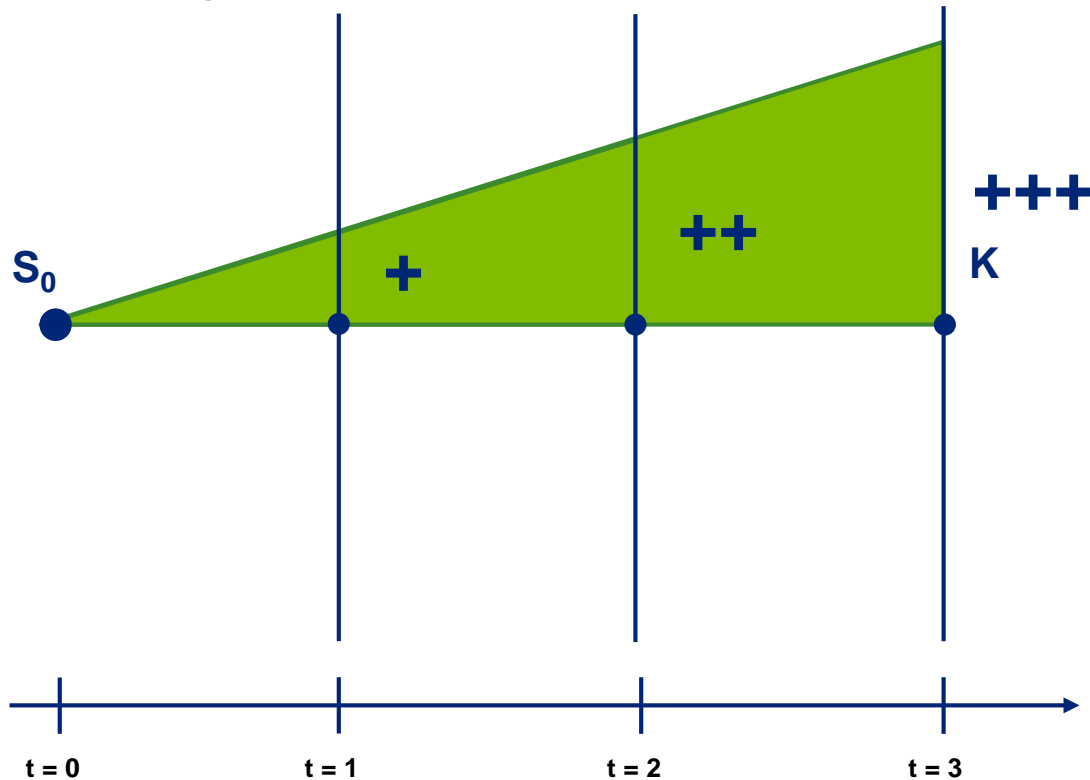


4.1. What is an option and what drives its value?

Timing

Let's consider...

A call, i.e. right to purchase at price K
with $K=S_0$



T is the date at which
the option can be
exercised

The longer the timing,
the more dispersed
will be the future price
of a stock

Therefore as the
timing increases, so
does the option value

Valuation

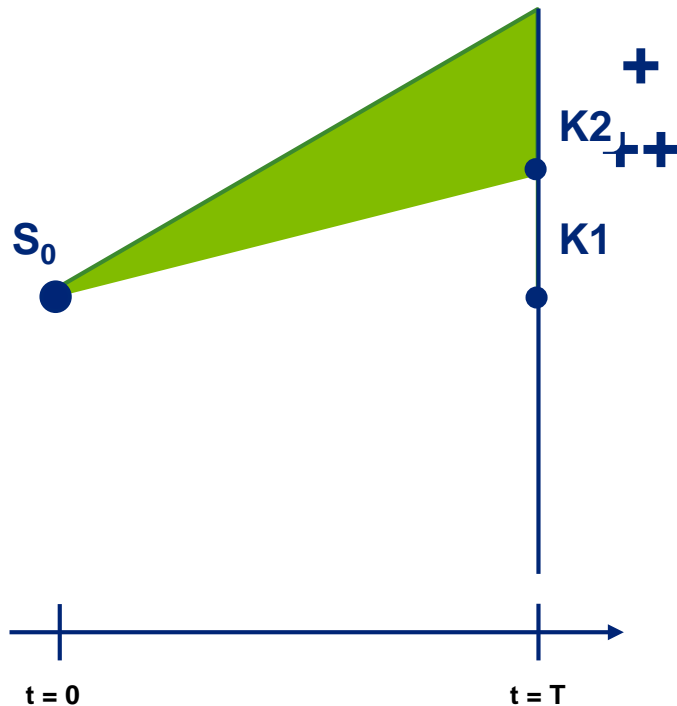


4.1. What is an option and what drives its value?

Strike Price

Let's consider...

A call, i.e. right to purchase at price K
with $K=S_0$



K is the price at which the
stock can be purchased at
time T

... Let's increase K from $K1$ to $K2$

The higher the strike price, the
less dispersed will be the
payoff of the option

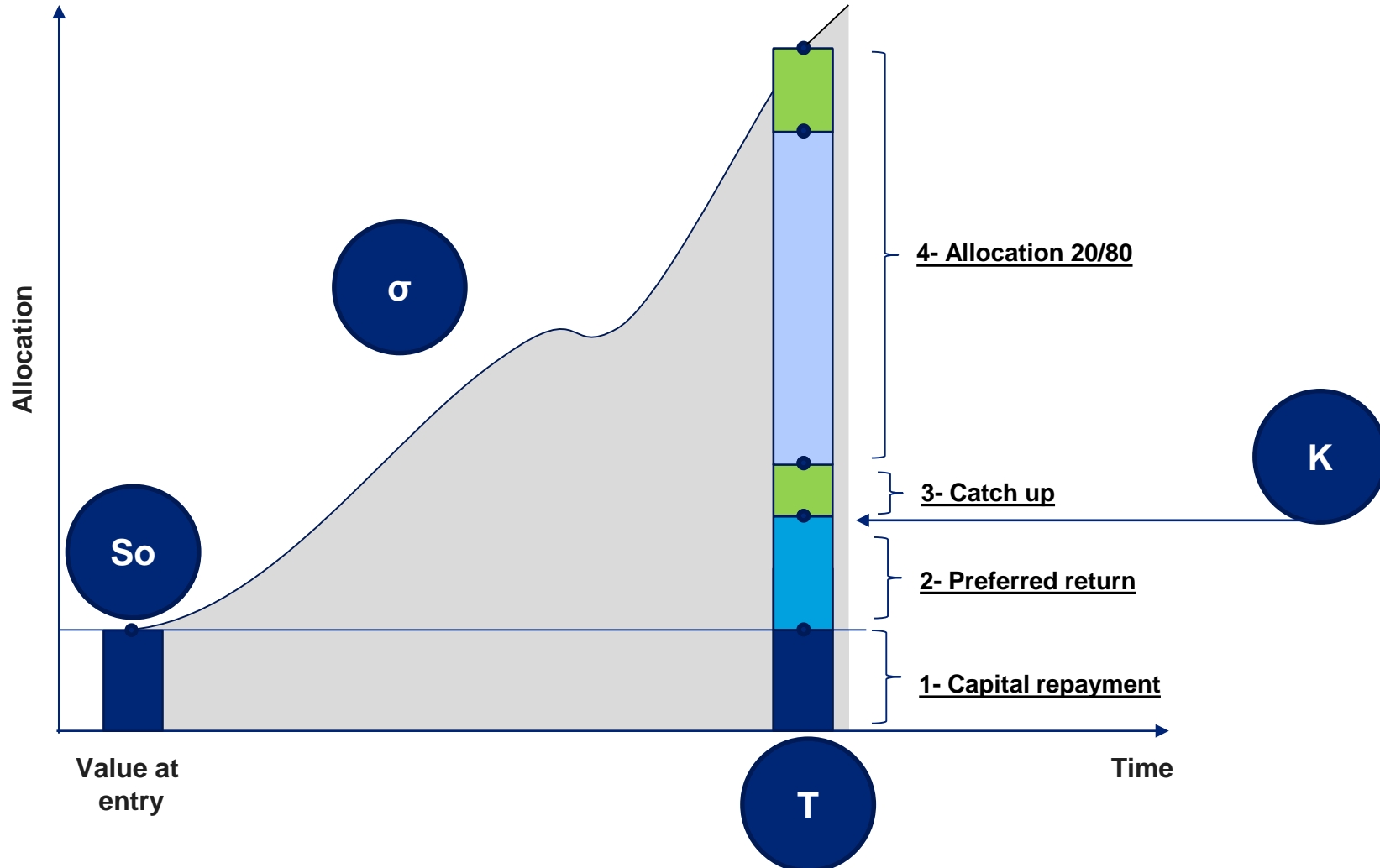
**Therefore as strike price
increases, the option value
decreases**

Valuation

4.1. What is an option and what drives its value?

Link between incentive plans and options?

■ Cash flows towards shareholders
■ Cash flows towards managers



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4.2. Find the appropriate valuation methodology?

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Valuation

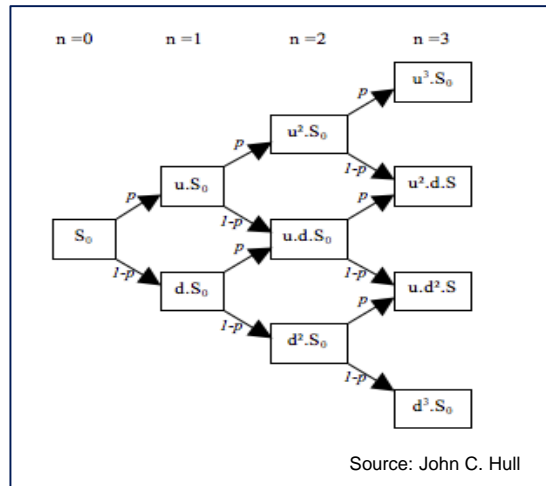
4.2. Find the appropriate valuation methodology?

3 main valuation methodologies used

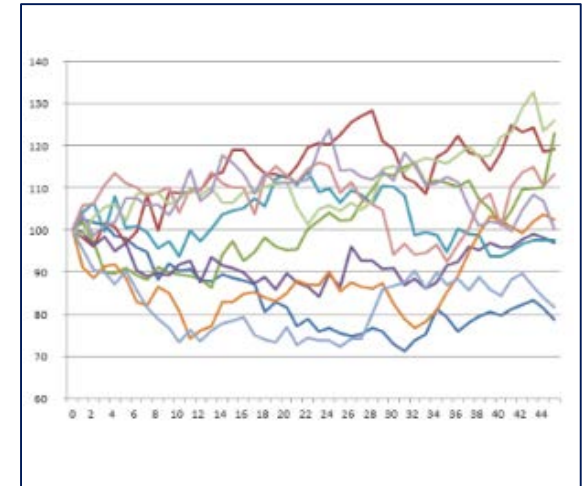
Black & Scholes formula

$$c = S_0 N(d_1) - K e^{-rT} N(d_2)$$

Binomial approach



Monte Carlo approach



Increased Tailoring/Increased Flexibility



Increased Simplicity

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Valuation

4.3. Valuation process

1 – Fund structure understanding

- Holding structure
- Debt repayment
- Level at which plan is put in place

2 – Waterfall understanding

- Preferred return: usually 10% to 20% p.a. depending on underlying volatility
- Catch-up: not always included
- Allocation rule: fixed or variable (depending on CoC, EBITDA,...)

3 – Value of underlying

- Business plan/historical financials necessary
- Usually done using different methodologies: DCF, trading/transaction multiples

4 – Option parameters

- Volatility (σ): usually 30%-40% for MEP/MIP, 10%-20% for carry (diversification)
- Maturity (T): usually 4-6 years
- Strike (K): corresponds to +/- to preferred returns (usually at least at 2.0x underlying val.)

4 – Option methodologies

- Black & Scholes: necessity to simplify waterfall using combination of calls/puts
- Monte Carlo: necessity to model fund and waterfall cash flows

Option value?

- Very dependant on structuring of the fund and plan

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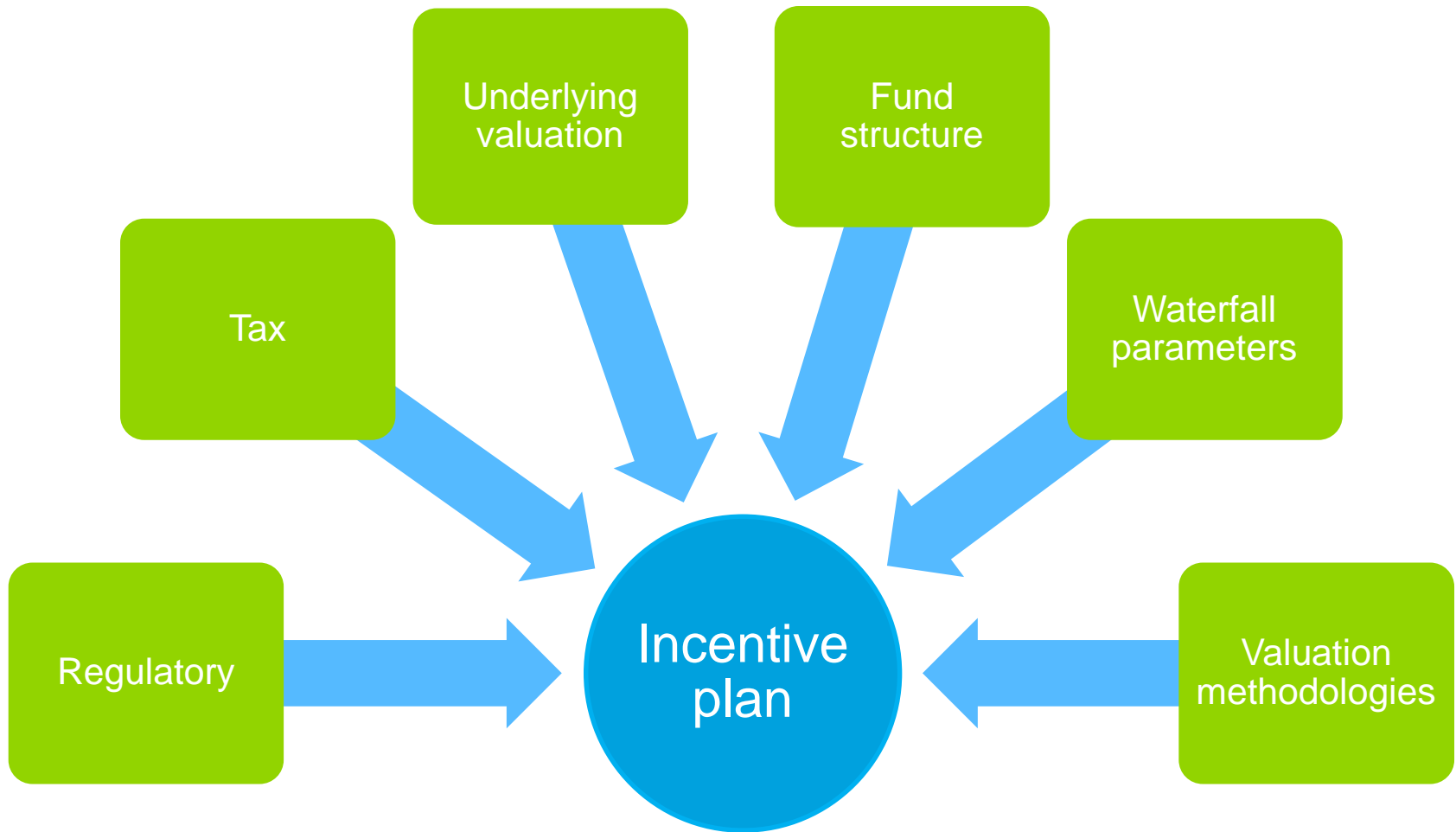
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Conclusion



Q&A

Thank you for listening

If you have any questions or comments, please contact valuation@deloitte.lu

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