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**Funds. People. Incentives.**

Global Employer Services whitepaper

Volume 2

In the Middle East since 1926

Businesses think long term in terms of their organizational objectives, and in doing so they need to carefully consider how they will incentivize and reward key people who will help ensure those organizational objectives are met.

This whitepaper is designed to provide insights into different reward strategies and mechanisms that can be used by organizations to ensure their key people are retained, incentivized, and motivated to achieve long-term goals.

Many of the countries in the region have published long-term strategic visions. For example, the Saudi Vision 2030 is a plan aimed at diversifying the economy and achieving sustainability. The recent immigration policy in the region is also geared towards the long-term. For example, the potential for individuals to obtain 10-year visas in the UAE will attract key talent to the region and help retain it. Government policy is therefore clearly targeted towards strategic objectives.

Businesses also think long term in terms of their organizational objectives, and in doing so they need to carefully consider how they will incentivize and reward key people who will help ensure those organizational objectives are met.

There is an opportunity for businesses in the Middle East to implement well-thought out, long-term reward strategies that are in line with organizational objectives and global best practices. These strategies can significantly contribute to the sustained performance of the business.

**Volume 1 – Introducing long-term incentives**

This volume explains how incentive plans can impact different organizational stakeholders. It also describes the more common reward mechanisms used globally, being:

- Cash-based mechanisms
- Performance shares
- Leveraged equity mechanisms

Some of the key considerations in relation to reward arrangements for organizations operating in the Middle East are also highlighted, such as:

- Aspects relevant to designing arrangements
- Communicating the benefits of the plan to participants and third-party investors
- Implications for the organization’s financial statements
- Potential tax or social security implications

**Volume 2 - Funds. People. Incentives.**

Given the significant role that investment funds play in the regional economy, this chapter provides an insight into how investment funds can incentivize key business personnel.

It provides an overview of how funds that invest for the medium and long term can implement reward arrangements, including the mechanics of carried interest, sweet equity, and co-investment.

Also considered are:

- The factors that funds acquiring a minority stake in organizations should analyze
- The dynamics that determine how much value should be delivered to key people
- How people who cease to be part of the organization can be treated if value has not yet been delivered (e.g. good/bad leaver provisions)

# Funds. People. Incentives.
## An insight into how investment funds can incentivize their key people

Investment funds, whether they are sovereign wealth funds, private equity funds, family offices or others, play a crucial role in the Middle East economy. The people involved in managing the investment funds, and if applicable, the companies that the funds invest in, are therefore also crucial.

Whilst there are numerous different types of funds, it will be important to attract and incentivize key people in order to maximize returns for investors for all funds. However, different reward structures can be implemented for funds who invest with a view to make gains in the medium term, compared to those who seek to hold assets (including portfolio companies) for the long term.

### Funds investing for the medium term

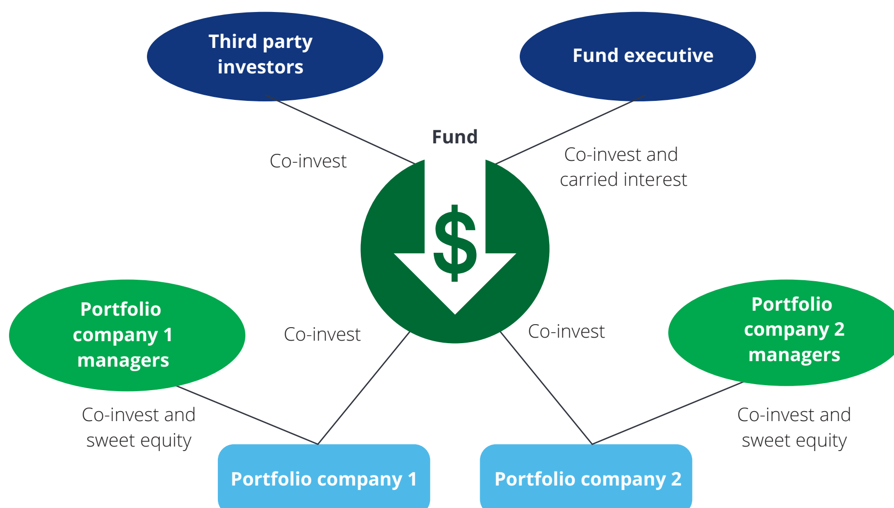
The simplest structure is for fund executives or portfolio company managers to receive bonuses by reference to current year profits. However, the risk with this approach is that the individuals managing the funds or portfolio companies may be inclined to prioritize short-term wins over the best interests of the investors.

In order to mitigate this risk, leveraged equity mechanisms are used to reward key people involved in managing funds and portfolio companies, where there is an intention to exit in the short to medium-term.

Participants may pay to acquire a combination of equity and/or debt interests. A portion of these will be acquired on the same terms as third-party investors (the 'co-invest'), while a portion will only reward the participant after a set performance hurdle is achieved (the 'incentive equity'). The incentive equity may also be referred to as carried interest for fund executives, or sweet equity for portfolio entity managers.

> Different reward structures can be implemented for funds who invest with a view to making gains in the medium term, compared to those who seek to hold assets for the long term.

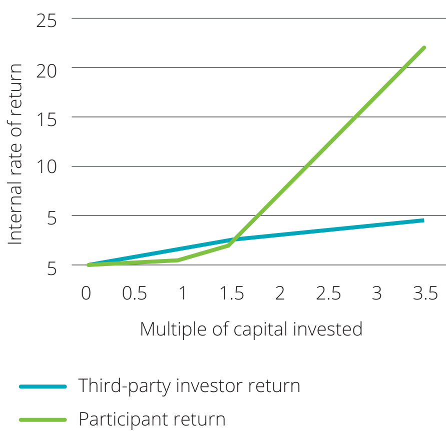
**Figure 1**



As individual participants may be required to pay for these equity interests, consideration should be given as to how they can fund their upfront investment. In some cases this may be lent to them.

The performance hurdle will typically be based on achieving a target internal rate of return or a multiple of capital invested. Once the hurdle is achieved, participants can potentially benefit from significant upside potential, which can be proportionally greater than the returns received by third-party investors.

**Figure 2**




Reward flows to fund executives/portfolio managers at the same time that cash is returned to the third-party investor, and so the objectives of the participants and the third-party investor are clearly aligned.

As these arrangements can be complex, a simpler cash-based approach could be an effective and simpler alternative for the incentive equity. Commercially though, the co-invest can deliver real "skin in the game," which is harder to achieve without an upfront investment by the participant. Also, the co-invest creates an additional layer of alignment which applies both in upside and downside scenarios.

## Funds investing for the long term

There is a different challenge for funds that invest for the long term, because any exit may not be envisaged for a number of years (if at all) – and therefore if the reward strategy above is used, the participant may have a considerable wait before any benefit is realized.

In this case, organizations can start by awarding equity instruments to their key personnel at the time the initial investment is made. They can then engineer partial liquidity events at set intervals (e.g. in years 3, 5 and 7) where the individual has the option to sell a portion of their equity instruments to the investor or other party for market value.

Market value can either be determined by a third-party valuation exercise or be based on a simple internal calculation e.g. a multiple of earnings.

Key personnel are incentivized as they can benefit from the increase in value of the equity instruments held between initial investment and subsequent disposal, which can be engineered to take place at defined intervals.

These types of arrangements can also be replicated by cash-equivalent or 'phantom' arrangements, which can achieve a similar outcome. However, when the value of the fund/portfolio company increases, a mechanism using equity instruments can be more attractive from an accounting perspective.

## Funds acquiring a minority stake

Where a fund acquires a minority stake in a portfolio company, it is essential that the incentive arrangements in place are reviewed to ensure that the objectives of the portfolio company management team are aligned with that of the fund.

An appropriate incentive arrangement would be one that ensures that the management team members are incentivized to:

- Maximize the value of the portfolio company
- Aim to deliver value at a time which is consistent with the timing envisaged by all investors, not just the majority investor or management team
- Contribute to mitigating conflicts of interest (e.g. their personal positions following any future sale of the portfolio company)

## Leaver conditions

A key area of interest is often around conditions in cases where key personnel – either fund executives or portfolio company managers – want to leave the organization. Where key personnel are investing cash, a prime concern will be the terms on which they will recover their initial investment.

For this reason, special conditions are normally attached to these types of equity interests, which govern how individuals will be treated if they cease to be part of the organization.

The majority of organizations will distinguish between 'good leavers' and 'bad leavers'. For many, a good leaver will be narrowly defined and will normally be restricted to one who ceases employment by reason of ill health, disability, or death,

A common question is how much equity should be delivered to participants. Delivering too little will not incentivize the participant, but delivering too much could dilute the interests of third-party investors and encourage excessive risk taking.

or, occasionally, by reason of redundancy. Conversely, bad leavers are individuals who leave for any other reason.

Whether an individual is deemed to be a good leaver or a bad leaver can impact the price which the individual will receive on disposal of their equity interests, or potentially even their ability to recover the full amount of their initial investment. The usual position is that a good leaver will receive market value for their equity interests, whereas a bad leaver will receive the lower of the amount they initially invested, or market value.

The distinction between good leavers and bad leavers, and the conditions which will be applied to them, is particularly relevant in a region where a high proportion of the workforce are expatriates and may need to leave their employment for reasons unrelated to the organization. Organizations should also remember that the overall objective of any incentive arrangement is to encourage high performing key personnel to stay, without creating barriers for individuals to leave where it would be in the best interests of the organization for them to do so.

### How much value to deliver?

A common question is how much equity (or cash equivalent) should be delivered to participants. Delivering too little will not incentivize the participant, but delivering too much could dilute the interests of third-party investors and encourage excessive risk taking.

There is never a right answer to this, but some of the factors that determine the level of equity that should be delivered to participants are:

- The fund or portfolio company value. Generally, the percentage of incentive equity (or cash equivalent) reserved for participants is lower where the portfolio company or fund value is higher. However, in absolute terms, the value of incentive equity acquired by the participants is higher for funds or portfolio companies with higher value.
- Whether there is a competitive bid process for a portfolio company or significant competition for talent. In such cases a higher percentage of incentive equity (or cash equivalent) may be offered to participants.
- The value generated under legacy incentive arrangements or the amount participants are required to invest alongside third-party investors. The greater these are, the higher the percentage of incentive equity normally offered.

### Tax considerations

Consideration should be given to any potential tax implications on a future disposal of equity interests, depending on the employee's personal circumstances. The gain derived on disposal may be treated as an investment return, as opposed to employment income, which in many cases is subject to a different tax treatment.

### A unique challenge...

Incentivizing people in relation to investment funds is very different from incentives in other organizations. This is because these businesses can grow very quickly and there is a unique relationship between the investors and those responsible for managing the investment. A properly incentivized fund manager or portfolio company manager can deliver outstanding returns for third-party investors, so the benefits of proper incentivization can be significant. Organizations should therefore, carefully consider these arrangements.

# Contacts

Deloitte has a growing team of Global Employer Services (GES) specialists, covering the entire GCC region; details of our senior contacts are set out below.

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