

The power of Exit Protection

For Management Equity Plans

VDV
INSURANCE
CONSULTANTS





Look beyond the Exit

Many of our clients tell us that they wish they would have met us earlier. Usually, clients who tell us this are involved in the many curative cases that seek solace in our practice; persons whose wealth jump as a founder or from a management equity plan was threatened with a complete reversal of fortune due to massive tax claims post-Exit. These persons are CEOs and CFOs who participated in Management Equity Plans (MEPs) or founders whose companies were successfully sold and 4 or 5 years after their Exit faced tax claims with the potential of a full wipeout of the wealth jump they had made upon Exit.

In response, Vunderink De Vries B.V. introduced Exit protection for MEPs which is backed by our IDA® platform that has successful track record, second to none, in MEP tax protection. M&A insurers back our platform because of that track record, both curative and preventive, in many countries across the globe. The power of Exit protection is found in securing that the incentive of high Exit values is a true life changing opportunity for executives without the fear of losing everything afterwards.

With that protection, managers can commit to (roll-over) equity without the fear of getting in severe financial trouble, which results in higher performance towards Exit and higher Exit values.

When the heat of the deal is on, you don't want a Due Diligence exercise to become the revelation of bad news for the managers. You don't want them to suddenly shy away from supporting the best Exit price possible or to put their foot on the brake.

On request of various clients and business relations, we have taken the effort to share the insights of Exit protection with a wider audience in M&A. We hope to avoid that more people who haven't met us yet will meet us in curative care after Exit.

In this leaflet we provide a look beyond the Exit. This is meant to be used before Exit, so don't get us wrong: the message is to take action before Exit, not afterwards.

We would be delighted to share more insights over a cup of coffee when convenient.

Yours sincerely,

VDV Insurance Consultants B.V.

Management Equity Plans (MEPs) are strong instruments to drive performance. Private Equity firms use MEPs in almost all of their investments. The carrot & stick approach has proven value over decades of Private Equity practices. The stick is the manager's personal money invested in equity (first loss when performance lags behind). The carrot is the prospect of life changing wealth creation upon Exit. The latter requires that performance has been good and the company is sold for a good price. Leverage instruments used within the capital structure (fixed yield instruments such as preference shares and shareholder loans) serve to create the stick. The stick hurts the manager's investment if the enterprise value (EV) is lower

than the sum of all (net) debt plus preferred shareholder instruments. That's what the stick is designed for: enterprise value must grow faster than the financing and preferred yield instruments of the sponsor(s). And when EV value increases well, the leverage instruments work the other way around: the value growth of the levered shares accelerates. IRRs of 60% up to and over 200% IRR for managers are common in Private Equity's MEP arena.

Despite the structure that tends to be used for MEPs as a matter of tax optimization, it is the yield that defines tax treatment. Yield is about economics. And structure-fixed approaches that neglect the fact that economics define

tax treatment, fall victim to total wealth destruction for managers as structure can be chosen freely but cannot be used to defend against yield disproportionateness claims from the taxman.

We see curative cases from CEOs and CFOs who seek our help many years after their Exit. See below picture illustrating real cases.

Tax valuation (incl. yield proportionateness assessments) is about value methods that according to tax courts' evidence rules rank higher than any opposing value. Tax valuation is a very specific expertise that should never rely on non-tax valuations.

Myth-buster 1: the Exit is not the final event for MEP participants

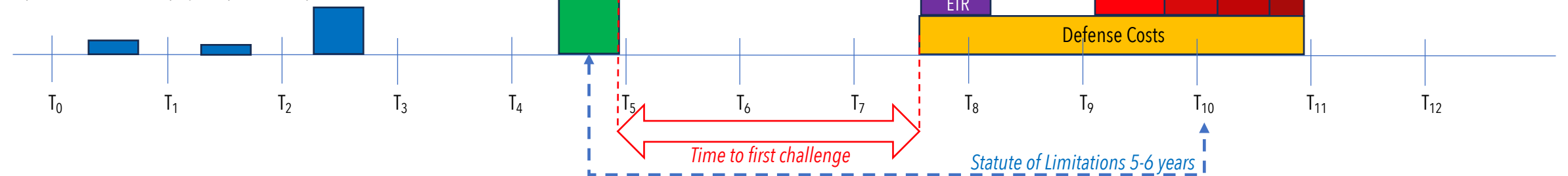
It may take 5-6 years before MEP participants know what their personal wealth position from the Exit truly is. That is not a good incentive for high performance towards Exit.

Myth-buster 2: Tax can be higher than 100% of proceeds.

Myth-buster 3: Structure fixation cannot provide for a safe harbor.

Myth-buster 4: Rulings offer very little protection in reality.

Captable events such as equity sale/purchase, capraise, dilution



You can plan and control your Entry and your Exit. Controlled auctions are 'controlled' for good reasons. But you cannot control the third major event: tax (re)assessment after Exit. For management, the Exit isn't the final verdict. It is only 3-6 years after Exit when the final verdict is known, unless management and Company transfer the risk of (re)assessments to a third party. Private Equity funds will never assume that risk themselves as they want no strings attached after Exit. So the insurance market is your best third party to work with.

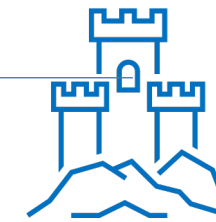
The reason to consider transferring the risk to the insurance market is simple: the tax office will never waive their lawful right to review events in retrospect. This is the privilege that tax authorities have been granted and they are in their best position to audit, control and correct tax positions once all facts are carved in stone. Looking back is the taxman's stronghold. And that is not just because they can patiently dig deep into a long history of 'frozen facts', but also because levy interest can be added to the tax charge, which increases the tax bill as time passes by. Time is against the taxpayer.

And time is also what the taxman needs in order to go back to all events that eventually caused a yield to be high or low. If historic events cause a yield to be disproportionate by tax valuation standards, the yield is requalified into employment income. If on top of that specific tax rules that target excessive employment income have been ignored, the requalification into employment income may trigger more than one taxation. Add to this levy interest as well as structure and compliance failures within the MEP setup, and double, tripple and even quadruple taxation arises.

MEP stakeholders must understand that the taxman's stronghold is to look back after Exit to assess yield proportionateness with the benefit of hindsight

Final and formal tax judgment always hinges on yield proportionateness, to be assessed on the basis of tax valuation principles

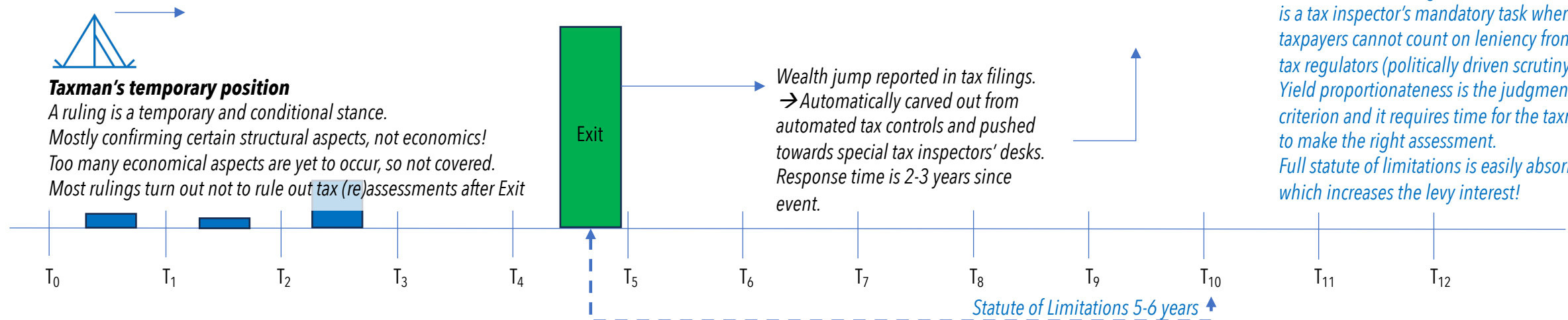
- Requalification into employment income (wage and personal income tax) defined by yield disproportionateness
- Is yield proportionate? That requires looking back into all capital structure related aspects, from initial investment to Exit
- **Looking back to T_0 and all events since (capraises, dilutive events, add-on investments, terms impacting economics)**



Taxman's stronghold:

The taxman's mandatory mode of operation is retrospective control: look back and judge.

To distinguish between low capital gains tax treatment and high taxed labor income is a tax inspector's mandatory task whereby taxpayers cannot count on leniency from tax regulators (politically driven scrutiny). Yield proportionateness is the judgment criterion and it requires time for the taxman to make the right assessment. Full statute of limitations is easily absorbed, which increases the levy interest!



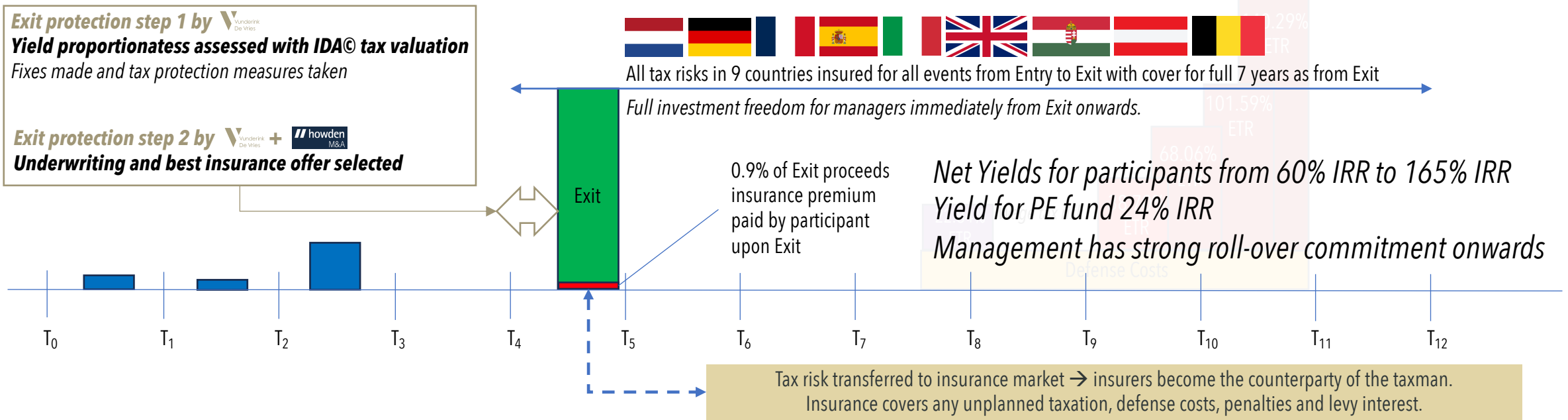
As said, MEP tax protection is all about economics. More specifically: it is all about the assessment of yield proportionateness. This shall be done on tax valuation principles. The use of valuation methods from outside the tax domain must be avoided, as these will create more issues than they may ever resolve. Despite general belief, a lot of protection can be provided even after an MEP has been setup. As long as the Exit is not realized, we tend to fix many flaws in MEPs, in order to restore yield proportionateness, validated in conformity with tax principles.

The Exit will, however, not become a full incentive for management if they have to rely on an advisor. If the taxman challenges successfully, the advisor is not on the hook (unless professional liability can be invoked, but that is a long way to go). The only protection that truly brings value to an Exit, is protection where the risk of failure is on the balance sheet of a strong counterparty with an A+ credit rating. Transferring the tax risk from the target company's balance sheet and away from the manager's personal liability to a third party, is an optimal way to secure that Exits are true incentives for high performance

of management teams. Real cases where we have implemented Exit protection will show you that the economics of Exit protection are far better than any alternative strategy. With an insurance premium component of 0.9% of management's net Exit proceeds, on a deal that was closed in 2023, the real cases can show you why the economics of Exit protection are often considered a no-brainer for executives. It will cost something, but the alternative is very negative and may cause managers to hold back during the M&A process.

Myth-buster 5: issues that can result in yield disproportionateness can often be resolved before Exit
Myth-buster 6: the economics of a Exit protection plan (including fixes made) are an absolute win

A case study can easily show how powerful Exit protection is:



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