

EXIT PHASE

How does a MIP waterfall work, and what determines the outcome for participants?

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The waterfall is nothing more mysterious than an ordered list: when the business is sold, the proceeds flow through a sequence of claims, each of which must be satisfied before anything reaches the next. What makes it consequential for a MIP is where management's equity sits in that sequence: deliberately near the end, where the risk is highest and the leverage on a good outcome is greatest. That positioning is the entire economic logic of sweet equity, and it is also why participant outcomes are so sensitive to facts that seem, during the hold, like technicalities.

This article walks through the tiers in plain language, then looks at the handful of variables that actually move the outcome, and finally at why the number so often surprises the people in the plan. One caveat before we start: waterfalls are defined by the specific documents of the specific structure. What follows is the common architecture; your shareholders' agreement is the only version that pays.

The tiers, in the order the money moves

In a typical PE structure, sale proceeds work through a sequence like this. First, debt and transaction costs: external lenders are repaid and the costs of the deal are settled before any equity holder sees anything. Second, the institutional preference: the fund's investment usually sits largely in preferred instruments (shareholder loans, preference shares) that carry a fixed return, and these are repaid, with their accrued interest or coupon, ahead of the ordinary equity. Third, the ordinary equity, where the fund's strip and management's sweet equity sit, shared in whatever proportions the structure defines. And sometimes fourth, ratchets or hurdles: mechanisms that increase management's share once the fund has achieved defined return thresholds, rewarding outperformance with a larger slice of the top.

The essential insight is that management's equity is a claim on what remains, not on the headline price. A business sold for a number that sounds triumphant can still leave a thin residue after debt and preference, and a modest-sounding uplift in enterprise value can multiply the management outcome several times over, because every additional euro past the preference flows disproportionately to the last tier. That asymmetry is the design, not an accident: it is what makes the plan an incentive rather than a bonus.

VARIABLE	WHY IT MOVES THE OUTCOME
Leverage at exit	Every euro of remaining debt comes out before equity; deleveraging during the hold flows straight into the equity tiers
The preference and its clock	A fixed return accruing over time; a longer hold means a larger preference to clear before ordinary equity participates
Timing of the exit	Interacts with the preference clock and with vesting: the same price in year four and year six produces different participant outcomes
Ratchet and hurdle terms	Step-changes in management's share around defined thresholds; small moves in price near a threshold produce large moves in outcome
The participant's own record	Vested balance, entry terms, and leaver history determine each individual's share of the management pool

Why the number surprises people, and how not to be surprised

Participant disappointment at exit has a small number of recurring causes, and almost none of them is the waterfall being wrong. People anchor on the enterprise value in the press release and forget that debt and preference come first. They think in gross terms and meet taxation for the first time at completion. They assume their full allocation participates when their vested balance is what counts. Or they hold a mental model of the plan formed at onboarding, five years and two refinancings ago, that no longer matches the documents as amended.

The remedy is unglamorous and sits squarely in administration. Build the model early, from the actual documents, and test it against the reconciled register. Update it when the structure changes, because every refinancing and equity round rewires the tiers. And communicate ranges rather than points: showing participants what the plan pays at three or four plausible exit values, net of the preference mechanics, calibrates expectations honestly without promising anything. A participant who has seen the shape of the waterfall reacts to the final number with recognition; one who carried a private guess reacts with grievance.

The waterfall calculation at completion is only ever as good as the record beneath it. Every ambiguity this series has described, an approximate entry value, a vague vesting date, an undocumented leaver, resurfaces here as a disputed input to the one calculation everyone cares about, computed under deal pressure, with lawyers on both sides. The model is arithmetic; the inputs are the hold's discipline, or its absence.

An honest note on what this article is not: the waterfall interacts with tax and with the legal terms of specific instruments in ways that vary by structure and jurisdiction. The model tells you what the documents pay; your advisers tell you what that means for each participant. Both conversations belong well before the exit, not during it.

What this means in practice

FOR FUND MANAGERS

Model the management outcome at the same time you model your own. The fund knows its return scenarios in detail; the management pool deserves the same rigour, because their behaviour in the final years is shaped by what they believe the plan pays.

Watch the thresholds. If the structure has ratchets or hurdles, know where the exit range sits relative to them. A process that lands near a threshold turns small price movements into large management-outcome movements, and that changes negotiation dynamics on both sides.

Refresh the model at every structural event. Refinancings and additional funding rounds change the waterfall silently. An out-of-date model is worse than none, because it is believed.

FOR CFOS AND MANAGEMENT TEAMS

Read your own documents once, properly. The instrument you hold, where it sits in the sequence, and what has to be cleared before it pays. An hour with the shareholders' agreement replaces years of corridor mythology.

Ask for scenarios, not promises. A range of outcomes at plausible exit values, net of preference mechanics, is a reasonable request and a fair basis for your own planning.

Keep your own record clean. Your outcome at completion is your vested balance applied to the waterfall. Everything this series has said about entry values, vesting dates and documentation is, in the end, about protecting that number.

One last thought

The waterfall has a reputation for complexity it does not quite deserve. It is an ordered list and some arithmetic; a competent model captures it in an afternoon. What gives it its reputation is everything it touches: leverage, time, thresholds, vesting, leavers, tax, and five years of accumulated record-keeping, all converging on one calculation that determines what the whole exercise was worth to the people who ran the business.

That convergence is exactly why the waterfall rewards early attention. Modelled early, tested against a clean register, refreshed at every structural change and communicated in honest ranges, it turns the exit from a reveal into a confirmation. That is the discipline, and it is the work we do at MIP Desk.

