

FOUNDATIONS PHASE

What is a management incentive plan, and how does it actually work?

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A management incentive plan, MIP, is the mechanism through which management teams in PE-backed businesses share in the value they help create. Understanding how it works, and how the capital structure determines who gets what at exit, is essential whether you are a fund manager structuring the programme or a manager deciding whether to participate.

If you are part of the management team of a private equity-backed business, you have almost certainly encountered the term management incentive plan, or MIP. You may have been asked to sign one. You may have questions about what it is worth, what happens if you leave, or how the numbers work at exit.

If you are a fund manager or CFO, you design and implement these programmes. But the terminology and structure vary across funds and jurisdictions, and the operational reality of running a MIP over a multi-year hold is more complex than the initial design suggests.

This article explains what a MIP is, how the capital structure works in practice, including the institutional strip and sweet equity, and how the exit waterfall determines the financial outcome for each party. All numbers in the worked example are mathematically precise.

The basic concept: aligning interests through equity

Private equity is fundamentally about creating value in a business over a defined period, typically three to seven years, and then realising that value through an exit (i.e. a sale or an IPO). The fund manager wants the management team to be as motivated as possible to build that value. The most effective way to achieve this alignment is to give management a meaningful economic stake in the outcome.

A MIP is the formal programme through which that stake is structured. Management team members invest in ordinary shares at the start of the holding period and participate in the sale proceeds at exit. The structure is designed so that management and the fund manager prosper together. A good outcome for the fund manager produces a great outcome for management, and that asymmetry is deliberate.

The capital structure: debt, preferred shares, and ordinary shares

When a PE fund acquires a business, it constructs a layered capital structure, combining senior debt, preferred instruments, and ordinary shares, that determines how the economics flow at exit. Understanding each layer is essential before the MIP mechanics can be understood.

Senior debt, €45m Bank financing at a floating rate. In this example, the loan is structured as a bullet, the full €45m principal is repaid at exit in a single payment. Interest (7% per year in this example) is paid annually in cash by the portfolio company from operating cash flow and does not accumulate as additional debt.

Preferred shares, €52.5m at 10% PIK Subscribed by the institutional investor. These carry a preferred return, here 10% per year, accumulated (PIK), meaning the interest compounds into the principal each year rather than being paid in cash. At exit, the full accrued amount is repaid ahead of the ordinary shares. The typical market range for the PIK rate is 8–12% per year.

Ordinary shares, €2.5m The residual equity. Ordinary shareholders participate in the proceeds only after the senior debt and the fully accrued preferred shares have been repaid in full. At 4.5% of total equity, the ordinary share pool is deliberately small, which is precisely what creates the powerful gearing effect for management, as we will show in the worked example.

The high proportion of preferred capital relative to ordinary shares is not coincidental. It creates a structural threshold that the business must exceed at exit before ordinary shareholders receive anything, and a powerful amplification effect above that threshold. This is the economic engine of the MIP.

The institutional strip and sweet equity: two instruments, two risk profiles

THE INSTITUTIONAL STRIP

The PE investor does not hold its preferred shares and ordinary shares as separate instruments. It holds them together as a strip, a single combined investment in a fixed ratio of preferred to ordinary capital. The precise ratio depends on the investment case and is agreed at deal inception. It can vary between transactions, ratios of 1% ordinary / 99% preferred, 2/98, 3/97, or other variations are all common in practice.

The strip serves an important alignment purpose: it ensures the fund participates in the ordinary equity alongside management, rather than sitting entirely in a senior, fixed-return position. Every euro invested through the strip is split in the same fixed ratio throughout the life of the deal. Critically, the PE investor invests exclusively through the strip, it does not hold any separate pure ordinary shares outside the strip.

SWEET EQUITY

The term sweet equity refers to the pure ordinary shares that are not part of the institutional strip, the most junior instrument in the capital structure, with no preferred component attached. These shares have value only above the structural break-even enterprise value, but above that threshold they benefit from the full gearing of the preferred stack.

Management's MIP consists entirely of sweet equity, pure ordinary shares, invested at the same price per share as the PE investor pays for its ordinary shares within the strip. Both parties pay €1 per ordinary share: *pari passu*.

INSTRUMENT	COMPOSITION	HELD BY	RISK PROFILE	RETURN PROFILE
Strip	Preferred ordinary shares in fixed ratio (varies by deal)	+ PE investor only	Lower, preferred component accrues regardless of performance	Predictable preferred return plus ordinary share upside
Sweet equity	Pure ordinary shares, no preferred component	Management (MIP)	Higher, participates only above break-even EV; zero below	Highly geared, significant upside if business performs strongly

The exit waterfall: a fully worked example

The following example uses the capital structure described above. All numbers are precise. The strip ratio in this example is approximately 4% ordinary / 96% preferred, this is illustrative and will depend on the specific investment case in practice.

CAPITAL STRUCTURE AND INVESTMENT AT ENTRY

INSTRUMENT	AMOUNT	TERMS	HOLDER
Senior debt	€45.00m	Bullet · 7% cash interest p.a.	Bank
Preferred shares	€52.50m	10% PIK p.a. · 95.5% of equity	PE investor (via strip)
Ordinary shares, PE strip	€2.25m	90% of ord class · €1/share · via strip	PE investor
Ordinary shares, MIP (sweet equity)	€0.25m	10% of ord class · €1/share · <i>pari passu</i>	Management team
Total deal value	€100.00m		

Management invests €250,000 in pure ordinary shares, 10% of the total ordinary share class, at €1 per share, the same price paid by the PE investor for its own ordinary shares within the strip. The PE investor's total equity commitment is €54.75m (€52.5m preferred + €2.25m ordinary, held as an integrated strip). There is no separate sweet equity held by the PE investor outside the strip.

POSITION AT EXIT, FIVE-YEAR HOLD

Senior debt: €45.00m (bullet, principal unchanged at exit). Annual cash interest of €3.15m (7% × €45m) has been paid by the portfolio company from operating cash flow each year, totalling €15.75m over the hold. This is a cost to the business but does not affect the exit waterfall.

Preferred shares at exit (10% PIK compounded over 5 years): $€52.50m \times (1.10)^5 = €52.50m \times 1.6105 = €84.55m$

Break-even enterprise value for ordinary shareholders: €45.00m + €84.55m = €129.55m Below this enterprise value at exit, the ordinary shares, both the PE strip ords and management's sweet equity, receive nothing.

EXIT AT AN ENTERPRISE VALUE OF €261.5M (2.61x ENTRY VALUE)

WATERFALL STEP	RECIPIENT	AMOUNT	CUMULATIVE
1. Senior debt repaid	Bank	€45.00m	€45.00m
2. Preferred shares repaid (principal + PIK)	PE investor	€84.55m	€129.55m
3. Ordinary shares, All remaining proceeds	ordinary shareholders	€131.95m	€261.50m
Total exit proceeds		€261.50m	

DISTRIBUTION OF ORDINARY SHARE PROCEEDS (€131.95M)

HOLDER	INSTRUMENT	ORDS HELD	% OF ORDS	EXIT PROCEEDS
PE investor	Strip ords	€2.25m	90%	€118.76m
Management (MIP)	Sweet equity	€0.25m	10%	€13.20m
Total		€2.50m	100%	€131.95m

TOTAL RETURNS

PARTY	INVESTED	FROM PREFERRED	FROM ORDS	TOTAL PROCEEDS	MOIC	IRR
PE investor	€54.75m	€84.55m	€118.76m	€203.31m	3.71x	30%
Management (MIP)	€250k		€13.20m	€13.20m	52.8x	121%

This is the gearing effect of the MIP in practice. Management invests €250,000 in pure ordinary shares and receives €13.2m at exit, a 52.8x return on their investment. The PE investor earns a strong 30% IRR, lower than management's multiple, but on a capital base 219 times larger and with the protection of a €52.5m preferred instrument that accrues regardless of business performance. A good outcome for the fund is a great outcome for management.

The same structure illustrates the downside. If the business sells at €129.55m, exactly at break-even, the ordinary shares receive nothing. Management's €250,000 investment is worth zero. Below break-even, this is true regardless of how hard the management team worked or how long the hold lasted. The preferred return is structurally protected; the ordinary share return is not.

A note on terminology: MIP, MEP, sweet equity

Throughout this article we use MIP as the umbrella term. Some funds and jurisdictions favour MEP (management equity plan); others speak primarily of sweet equity. In the vast majority of cases these terms describe the same underlying mechanism, pure ordinary shares held by management within a leveraged capital structure. The labels matter less than the design choices they encode. We unpack the nuances, and the more consequential question of pool sizing, in a separate article in this series: Beyond MIP vs MEP: the terminology, the sizing, and the conversations no one has →

Vesting and leaver provisions: what happens if you leave before exit

Two elements of any MIP that every participant must understand clearly are vesting and leaver provisions. Together they determine what happens to your ordinary shares, and their value, if you leave the business before the exit event.

VESTING

Most MIPs include time-based vesting, your full economic interest in the ordinary shares accumulates progressively over the holding period. A common structure vests a fixed percentage of shares each quarter over five years, with a cliff at the start during which no vesting occurs. If you leave before you are fully vested, you typically retain only the vested portion. All instruments are typically treated as fully vested at an exit event, regardless of where you are in the vesting schedule.

LEAVER CLASSIFICATIONS

When a participant leaves the business before exit, their shares are subject to a repurchase by the investor at a price determined by their leaver classification. Well-structured MIP programmes distinguish between three categories:

CLASSIFICATION	TYPICAL CIRCUMSTANCES	VALUE OF INSTRUMENTS
Good leaver	Death, permanent ill-health or serious disability; redundancy; or a participant determined by the board to be a good leaver at its discretion	Market value of vested shares. Unvested shares typically lapse or are bought back at entry price.
Early leaver	Neither a clear good leaver nor a bad leaver, for example a mutual separation, or a departure where circumstances are ambiguous. Often subject to board discretion.	Lower of market value entry value for unvested shares. Vested shares typically at market value. Board retains discretion in most programmes.
Bad leaver	Voluntary resignation; termination for cause; material breach of the shareholder agreement, or articles of association, or applicable board regulations	Lower of market value entry value for all shares, both vested and unvested. In practice, this typically means repurchase at the original entry price.

The precise definitions of each category, and the financial consequences, are among the most heavily negotiated elements of MIP documentation, and among the most frequently disputed in practice. The boundary between good, early, and bad leaver is rarely as clear in real situations as the base definitions suggest. We cover this comprehensively in a separate article in this series: [Good leaver, bad leaver, and everything in between.](#)

An important nuance: the investor typically has the right, not the obligation, to purchase shares from a leaver at the relevant price. If the business is performing strongly and a departing participant is classified as a bad leaver, the investor will almost certainly exercise that right. If the business is underperforming and the shares are worth less than the entry price, the investor may choose not to.

What this means for management teams

If you have been offered a MIP, there are several things worth understanding clearly before you commit.

The potential upside is real, but so is the downside. You are investing real capital in pure ordinary shares. If the business sells at or below the break-even enterprise value, those shares may be worth nothing. The MIP is not a free option, it requires genuine financial commitment and carries genuine risk.

Understand what you are investing in. Know your ordinary share allocation, the entry price, the vesting schedule, and the leaver provisions. Know the difference between good, early, and bad leaver classification, and whether the board has discretion to determine your classification. This can have a material financial consequence.

The leaver classification often sits with the board's discretion, sometimes with very little objective criteria attached. In practice this means: the people who decide whether you leave as a good, early, or bad leaver are the same people who benefit financially from the classification. This is not necessarily a problem, but it is something to understand before you sign, and something worth raising during negotiation if you have the leverage.

The documentation matters. The terms of your participation are set out in legal documentation. Read and understand it, ideally with independent legal advice, before signing. Pay particular attention to any non-compete and non-solicitation provisions, which typically survive your departure.

Your participation must be formally registered. A verbal commitment or informal confirmation is not legally sufficient. Your participation must be documented, signed, and recorded in the participant register. Until it is, your economic interest may be unenforceable.

One of the most common issues we encounter is management team members who believe they are MIP participants, because they have been told they are, but who have never signed the underlying documentation. In a well-administered programme, this cannot happen. In practice, it happens frequently.

What this means for funds and CFOs

For funds and portfolio company CFOs, the MIP is not just a design exercise at entry, it is an ongoing administrative responsibility for the full duration of the holding period.

The programme must be administered throughout the hold. Participants join and leave. Add-on acquisitions bring in new managers who may or may not join the existing programme. Each event must be formally processed and documented, leaver classification confirmed, vesting assessed, share register updated, and all relevant parties notified promptly.

Documentation must remain current. The legal documents that set up the programme at inception rarely cover every situation that arises over a five-year hold. Amendments are needed. Board decisions on leaver classifications must be recorded in writing. A programme that is not actively maintained accumulates a backlog of unresolved issues that becomes progressively more expensive to remediate.

The programme must be exit-ready at all times. When a sale process begins, buyers and their advisors will scrutinise the MIP as part of due diligence. An incomplete participant register, undocumented leaver events, or a share register that does not match the underlying legal documentation creates delays and cost at precisely the moment you can least afford it.

A programme that is properly administered throughout the hold requires almost no preparation for exit. A programme that has been neglected requires weeks of remediation, generating significant legal costs and management distraction at exactly the moment you need everyone focused on closing the deal.

Quick reference: the key parameters of a MIP structure

The table below summarises the structural elements that define any MIP. Use it as a framework when reviewing your own programme, or when designing one. All parameters in the right-hand column reflect the worked example in this article.

PARAMETER	WHAT IT MEANS	EXAMPLE VALUE
Total deal EV	Enterprise value at acquisition, the total price paid for the business	€100m
Senior debt	Bank financing. In a bullet structure, principal is repaid in full at exit. Interest is paid annually in cash by the portfolio company.	€45m (45%)
Preferred shares	Held by the PE investor via the strip. Carries a fixed PIK return (8–12% typical) that accrues into the principal over the hold. Repaid ahead of ordinary shares at exit.	€52.5m (52.5%)
Ordinary shares (total)	The residual equity. Split between the PE investor (via strip) and management (via MIP). Participates in proceeds only after debt and preferred are fully repaid.	€2.5m (2.5%)
Preferred as % of equity	The higher this percentage, the greater the structural gearing for management. Directly determines the break-even EV and the management MOIC at any given exit.	95.5%
Strip ratio	The ratio of preferred to ordinary shares in the PE investor's strip. Determines how many ordinary shares the PE investor holds. Varies by deal, depends on the investment case.	~ 96% pref / 4% ords
Management allocation	Management's share of the total ordinary share class, held as pure sweet equity. Pari passu with the PE investor's ordinary shares at the same price per share.	10% of ords = €250k
PIK rate	The annual rate at which the preferred instrument accrues. The higher the rate and the longer the hold, the higher the break-even EV, and the higher the management MOIC if the business performs.	10% p.a.
Hold period	The number of years between acquisition and exit. Directly affects how much the preferred instrument accrues, and therefore the break-even EV and the available ords pot.	5 years
Preferred at exit	Principal + accrued PIK after the hold period. Calculated as: $\text{prefs} \times (1 + \text{PIK rate})^n$ where n = hold years.	€84.55m
Break-even EV	The minimum enterprise value at exit at which ordinary shareholders receive anything. Below this, management's investment is worth zero. Calculated as: senior debt + preferred at exit.	€129.55m
Exit EV	The enterprise value at which the business is sold. Determines the proceeds available for ordinary shareholders above the break-even.	€261.5m (2.61x)
Management MOIC	Management's total exit proceeds divided by their initial investment. Highly sensitive to exit EV, small changes in exit value produce large changes in management MOIC.	52.8x

PARAMETER	WHAT IT MEANS	EXAMPLE VALUE
PE IRR	The PE investor's annualised return on their total equity investment, including both preferred and ordinary share proceeds.	30% p.a.

The most important insight from this table: management MOIC is disproportionately sensitive to exit EV. In this example, a 10% increase in exit EV from €261.5m to €287.7m adds €26m to the total ords pot, all of which flows proportionally to management. Conversely, a 10% decline in exit EV reduces the ords pot by the same amount. The gearing works in both directions.

MIP WATERFALL CALCULATOR

Model the exit returns for your own deal. Enter your capital structure, debt, preferred shares, strip ratio, management allocation, hold period, and exit EV, and the calculator does the rest. Includes a 12-scenario sensitivity table.

- Full waterfall model with all capital structure inputs
- Management MOIC and IRR, instant calculation
- PE MOIC and IRR, compared alongside management
- 12-scenario exit EV sensitivity table

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