Pearl Meyer

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Pre-IPO Compensation: Balancing Market Data with the Magic of a Start-Up

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Transcript

We tend to have a jumping point where oftentimes what can occur is the VCs as well as the independent directors sometimes over-correct for that objective market data. And what I mean by that is that they may or may not have been an environment where a significant amount of prevalence and market data was collected. And there is a nervousness that if every T isn't crossed and every I isn't dotted from a governance perspective, that they will be blasted by the shareholder community. And so another challenge that occurs is making sure that you're creating and designing a compensation program that is public company-compliant but doesn't lose sort of the magic that is the organization. I would say we spend a significant amount of time and I think it's time well spent because a lot of the CEOs, whether they are founders or non-founders of these pre-IPO companies, what they tell us is that they do not want to lose the essence of the organization in this process.

And if that is lost, they find that attracting and engaging their talent becomes problematic. And so from that viewpoint that's another education aspect is that we don't want to overcorrect for becoming market compliant because then we just, we're no longer using compensation as a competitive advantage. As long as the information and the counsel is grounded in significant data gathering and I think the next step post that data gathering is not to just accept the data as it is, but to form that data in a way that makes sense for the organization and the growth profile. And the very last challenge, and this has come up for a past few clients of ours and it's an interesting one, is that the...given that the IPO tends to be the sort of monumental event for a pre-IPO company, it can also be a very emotional event.

It is almost like a saying to the organization, "Okay, we've made it." And what the senior team, especially, tends to feel is that there should be a significant payday at the point of that IPO. What the independent directors as well as maybe the VC or PE-backed directors, the vantage point that they're coming from is that, "Yes, you've made it, but now there's significantly more work to be done." And so you have this sort of difference of opinion and it plays out oftentimes in compensation where senior executives want to be rewarded in the new comp program for the value that has been created, not necessarily the value that is the... not necessarily for the future value creation. And so that push and pull, it oftentimes results in sometimes special payments at the time of the IPO. A significant equity award allocation to ensure that there's value creation for the future, but also an appropriate recognition of past value creation.

However if it's done in an outsized way, because some of these organizations—they're having year-on-year revenue growth of 60%, 90%—they're increasing the enterprise value of the organization two to three times during their tenure. There can be expectation that this award should be of significant and great value. The problem with doing that is that now you have the public company governance environment coming into play as one of the dynamics that the organization has to deal with. And so having some large equity awards, performance-based or not, at the time of the IPO offering is perfectly acceptable, but it should all be done within reason and couched in what is actually happening in the marketplace.

And so there tends to be a communication dynamic that also has to come into play where the board needs to be very, very forthright with the executive team and counsel them that the wealth creation, there's been significant wealth creation to date. The IPO offering is in itself going to be a good wealth creation event. But there is also a long runway for even further wealth creation and counsel the executives in understanding that that is something that will come with time and the new shareholders within the company do believe it's in the company's best interest to ensure that the executives are appropriately motivated and so that dynamic comes into… plays out in, as I said an a multitude of ways. One in terms of the compensation, two in terms of the communication strategy that the board has with the executives and then three, the strategy in terms of what you are displaying to the broader shareholder community—that you are a serious public company with appropriate governance standards and you are handling compensation in a very much pay and performance type of way.

About the Author

Aalap Shah is a managing director at Pearl Meyer. With more than 20 years of experience, Aalap advises public and privately held companies on executive compensation issues, with focus on pay governance, pay-for-performance alignment, and incentive plan design. Of particular interest is the intersection between business strategy, people strategy, and compensation strategy, believing alignment of all three is required to design effective programs.

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