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LTIPs and Private Companies: Seven Questions

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Given the highly engaged shareholder—and stakeholder—bases and strict regulatory environment in which public companies operate, it's not surprising that their executive compensation practices receive the lion's share of attention.

But, what about private companies? Those that disregard best practices in executive compensation and talent management strategies do so at their peril, particularly if they compete directly with public counterparts. And, while the challenges they face can be quite different, these companies' private ownership offers some advantages, including the ideal environment for more creative pay plan design and the flexibility to find the "just right" pay structure for the business and its employees.

Salary and short-term, cash-based bonus programs are generally straightforward and may not differ significantly between public and private organizations. However, implementing long-term incentive plans (LTIPs) that replicate the value and upside offered by public-company equity programs can present private entities with a significant challenge.

There are seven key LTIP design questions that private companies should consider before implementing a new plan or modifying an existing one. These broad questions are exploratory and the answers will highlight potential paths, as well as "non-starters," from a structural perspective:

1. What is the company's vision, exit strategy or transition plan?
2. What is more important to emphasize: performance or retention?
3. Should we share "real" equity with our employees?
4. Should we provide in-service liquidity?
5. Who should participate in the LTIP?
6. Can we set and track performance metrics and goals?
7. Who has authority to approve the plan and administer it?

What Is the Company's Vision, Exit Strategy, or Transition Plan?

Incentive plans are most effective when they are specifically designed to support a company's long-term strategy and milestone objectives. In private company LTIP design, perhaps the most pressing question is whether the company has a clearly defined vision, exit strategy, or transition plan.

Defining the company's vision first sets the overall framework for the LTIP. It clearly articulates the long-term objectives of the business and, in doing so, communicates the types of behavior needed to get there. Part of a company's vision might also be to work toward a liquidity event or some other transition in ownership in the future. Established venture-backed firms, for example, usually work toward a liquidity event (or “exit”) over a three- to five-year investment time horizon, whereas family-owned or closely held businesses typically plan for leadership and ownership transitions over a much longer period, perhaps seven to 15 years.

Clearly defining your company’s vision and potential exit or transition strategy can be an important first step in the LTIP design process and will affect future decisions such as equity vehicles, performance metrics, vesting parameters and liquidity options. Over time, LTIPs will need to be reviewed and updated as these items evolve or become clearer.

What Is More Important to Emphasize: Performance or Retention?

Consider your primary objective for the LTIP: Is performance or retention your biggest priority? If it’s both, is one more important than the other? Or, perhaps the lack of LTIP opportunity is presenting challenges in your recruitment process when competing against public firms. In any scenario, spending time to identify and prioritize the reasons for the incentive plan and the desired outcomes is the most important factor in selecting the appropriate incentive vehicle(s).

In general, firms that push performance as the highest priority (typically venture-backed firms, startups, etc.) opt for appreciation-oriented vehicles such as incentive stock options (ISOs), non-qualified stock options (NQSOs) and stock appreciations rights (SARs). In contrast, companies focused on retention typically choose full-value vehicles such as restricted stock, restricted stock units (RSUs) or other types of “phantom” awards. While a blend of growth and retention awards is certainly possible, and in some cases advisable, using multiple vehicles is less common in private companies than in their public peers.

Should We Share ″Real″ Equity with Our Employees?

Sharing “real” equity means potentially transferring ownership of stock in your company to your employees over time. While this sounds obvious and straightforward, some private-company owners, particularly those run by founding family members, may be reluctant to part with real equity. Others, including venture-backed businesses and startups, cringe at the thought of providing anything other than real equity, given the culture in which they operate and the mindset they seek to create.

Ultimately, conveying real equity to employees means transferring control and diluting earnings for the current owners. If the thought of this and the various administrative headaches that come with real equity (e.g., securities registration, disclosure, reporting, etc.) aren’t an obstacle, then stock-settled awards are likely the best path to pursue.

Despite some negative perceptions, “equity- like” vehicles, including stock units and phantom equity, are much more common at family-owned and closely held businesses and can be extremely effective. Payouts remain linked to company performance or growth in value, yet they are settled in cash. While the economic benefits essentially mirror real equity over the vesting period, cash-settled awards have the disadvantage of not offering continued upside potential after the payout has occurred. Moreover, they can deprive recipients of some useful tax benefits that come with holding vested stock awards over time.

Should We Provide In-Service Liquidity?

To put this in non-technical terms, "Should we allow employees to get their money out during employment?" Seldom do we see startups and venture-backed companies offer this as a feature in their LTIP. Simply put, these companies are entirely focused on a potential future liquidity event and are seeking to maximize company value in the process. Ensuring that key employees remain fully committed to realizing this event is critical and offering them the ability to "cash out" not only hits company earnings and valuation, but it could also cause executives to take their eyes off the prize. These high-risk/high-reward incentive plans are very effective when the business and compensation strategy is clearly communicated and understood; however, they also have the potential to become dead ducks if it appears a transaction may not occur on the anticipated timeline—or at all.

It's a different story at family-owned businesses or closely held companies where the strategy is more geared to transition or leadership succession than an exit. With a much longer incentive and retention time horizon, in-service liquidity is a standard—and often expected—feature of many LTIPs and may be funded by the company through cash or shares placed in trust, or a qualified plan structure such as an employee stock ownership plan (ESOP). In fact, the lack of in-service liquidity alternatives at companies where an exit is not being considered can create an incentive to leave over time.

Who Should Participate in the LTIP?

Practices vary widely on this issue, and it's probably the most company-specific question. Assuming it's a non-qualified plan, it comes down to business culture and the mentality the organization is trying to build. Many will want employees to feel and act like owners, but it's possible not all levels of the organization will really value potential future equity above a higher salary today—in which case LTI awards may not be appropriate. There are also practical issues involved that might limit the number of LTIP recipients included in the plan. For example, in order to maintain their taxfavorable status, S Corporations are limited to 100 shareholders.

The general guidance is that, at a minimum, LTIP participants should be those with the greatest ability to affect results and drive value, usually the C-suite. From there, companies should consider adding employee levels or functions identified as high-performing/high-potential and susceptible to poaching by competitors.

Can We Set and Track Performance Metrics and Goals?

The extent to which LTIP vehicles and performance thresholds can be customized depends largely on the company's ability to define metrics, forecast performance and set long-term goals. If confidence is high in these areas, more sophisticated vehicles such as performance shares (or units) may be appropriate instead of (or in addition to) stock options and restricted stock/units. These awards are typically structured around one or more predetermined financial objectives, such as free cash flow or EBITDA, or other strategic initiatives like market share gains or product launches. With the ability to forecast accurately over a multiyear period, companies can be more surgical when it comes to targeting metrics that drive stakeholder value.

The reality, however, is that most private companies do not feel comfortable forecasting performance three to five years into the future or setting long-term goals. This is not because they are not capable, but because the industry or market simply offers too many unknowns that can quickly render a well-crafted LTIP obsolete. For these reasons, the prevalence of performance shares or units is relatively low among private firms. That said, even without a performance share plan, private companies must still identify key performance metrics, since they need to develop a basis for determining LTIP value. Some companies will "outsource" this process by conducting a periodic third-party valuation, but many establish an internal valuation model, such as a multiple of EBITDA.

Who Has the Authority to Approve the Plan and Administer It?

In a public company setting, the parties responsible for LTIP approval and administration are often clearer than they are for private companies. Typically the compensation committee is responsible for recommending the LTIP to the full board for approval, and administrative responsibilities (e.g., performance measurement, bonus tracking, etc.) fall on the finance and compensation departments within human resources.

However, these kinds of established governance structures are less common among private businesses. Absent installing a formal compensation committee or hiring an in-house compensation professional, private companies must work within whatever structure they have to approve and administer the plan. If a compensation committee or board has been established, we suggest using it for LTIP approval purposes, while being mindful of potential conflicts of interest. In terms of plan administration, including performance tracking and measurement, selecting a member of the HR and finance departments to work alongside the CEO as part of a "management committee" that advises and recommends to whomever approves the plan is a best practice and has shown to be effective.

Considering these seven questions is a useful first step in the private company LTIP design process. However, as with so many things in compensation, the devil is in the details. Spending the time to define the precise plan parameters appropriate for the organization will pay off in the end, helping create competitive advantage and driving incremental value in the long term.

About the Author

Rob James is a managing director with Pearl Meyer with almost 15 years of experience in executive compensation and finance. He serves as a trusted advisor to boards and senior management at public and private firms across North America. He works with companies in all industries, but he has in-depth knowledge and expertise in designing compensations strategies for organizations in life sciences and technology, particularly emerging and high growth companies that are pursuing or have recently completed a M&A transaction or public offering.

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