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Executive Compensation Checklist for Pre-IPO Companies

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Venture-backed private companies maintain executive compensation programs that are significantly different than public company programs. This does not mean a venture-backed private company that is planning an initial public offering (IPO) needs to immediately make drastic changes to its programs to conform to public company practices, proxy advisory concerns and regulatory issues. However, Compensation Committees of these companies should consider transitioning their programs and practices over a three-year period starting prior to the IPO and continuing for several years following the IPO. This pre-IPO checklist provides a roadmap to help Compensation Committees and management teams successfully transition their executive compensation programs over time.

1. Establish a Compensation Philosophy

A compensation philosophy serves as the foundation for all compensation decision-making including:

- Objectives of the compensation program
- Total pay mix (i.e., short-term vs. long-term; performance vs. retention/attraction)
- Desired competitive market position (e.g., peer group median)
- Pay-for-performance approach
- Use, type and amount of equity
- Approach to benefits and perquisites

Although still not common among public company practices, the Board of Directors should also discuss their preferred approach to the design and amount of Board pay through a philosophy statement.

Disclosing executive compensation practices and decisions and managing to a compensation philosophy is important since the approach a company takes must be disclosed in the Compensation Discussion & Analysis (CD&A) section of the public company's proxy statement. As a public company, the compensation philosophy disclosure does not need to be detailed, but it needs to accurately reflect how the Compensation Committee manages executive pay.

2. Develop a Public Company Peer Group

It is not unusual for a private company to prepare competitive pay analyses on an as-needed basis to address current issues and understand market practices. These analyses are generally not prepared annually and may not be based on public company practices. Most public companies, in contrast, review the total pay levels of their senior leadership team annually with direct comparisons to public company practices driven by CD&A disclosure needs and Say-on-Pay votes. The approach to constructing a public company peer group is an important step in ensuring the Compensation Committee understands public company practices and should follow these generally accepted practices:

- Use revenues, market cap, assets, industrial classification or other characteristics to select companies of similar size.
- Review business models to ensure peers have the same or similar businesses. (This is particularly important if a company's long-term incentive plan uses relative performance metrics. If the majority of peers do not have similar business models then performance comparisons will be distorted.)

Developing a public company peer group was once thought of as a simple exercise but peer group construction is one of the most important steps in establishing an executive compensation program. Poorly constructed peer groups have been blamed for excessive compensation levels as they are often one of the foundation stones that go into the construction and design of executive pay programs.

Further, with the increased use of relative performance measures, it is critical that the business models and cycles of the peers are aligned with the company. Without this alignment, performance comparisons and awards paid under incentive plans may not truly reflect a company's relative performance, resulting in incentive awards to executives that are either too small or too generous. For example, if the majority of peers have business models that are not as profitable as the subject company, then awards based on a relative comparison of profitability will result in inflated incentive awards.

3. Understand Equity Usage

Many private companies that are managing to an exit event set aside 8% to 15% of shares for management. Most of these shares are typically granted to the management team in a single equity grant, while the remaining shares are set aside for future grants to existing and new hires. In many cases, members of the management team may not receive a subsequent equity grant until the IPO. Assuming the cash compensation levels (salary plus bonus) are competitive, Compensation Committees have been comfortable that setting aside 8% to 15% of equity for management will result in fully competitive total pay levels, especially given the expectations of high equity returns upon a successful IPO exit.

In the past, it was not unusual for a private company to expect to have an exit event in a three-to-four-year time frame. In today's economy, particularly since the financial crisis of 2008, it is not unusual for a private company to have an exit event in eight or more years. The amount of time currently needed for an IPO event results in private companies using substantially less equity than a public company over a similar time period.

The following table illustrates this concept. Assume a private company issues 12% of outstanding shares to management. Contrast this to the amount of shares that could be granted to management of public companies. For purposes of this illustration, we show the mean and maximum amount of shares that could be granted to employees and Directors of public companies based on current Institutional Shareholder Services (ISS) guidelines. We also selected three industries for this comparison. These industries run the spectrum of low, medium and high users of equity.

Industry	Equity Burn Rates One Year ISS Mean	 ISS Max	 Four Years ISS Mean	 ISS Max	 Eight Years ISS Mean	 ISS Max
Utilities	0.82%	2.00%	3.28%	8.00%	9.84%	16.00%
Retailing	2.41%	4.16%	9.64%	16.64%	19.28%	33.28%
Pharmaceuticals & BioTechnology	3.65%	5.91%	14.60%	23.64%	29.20%	47.28%
Pre-IPO Company	12.00%	12.00%	12.00%	12.00%	12.00%	12.00%

We are showing a pre-IPO company that uses 12% of outstanding shares under all scenarios. The chart shows that over a four year period, the private company equity practices are reasonably competitive with public company practices but over an eight year period, private company equity practices become uncompetitive even when compared to industries that are traditionally modest users of equity. Under the latter result, a private company may experience attraction and retention issues as other opportunities may become more attractive.

4. Assess Executive Compensation Competitiveness & Design

The type of equity granted at private companies differs from public company practices as well. Private companies rely heavily on time-vested restricted stock and stock options and, in many cases, performance-vested options. This type of program is much different from public company practices where the vast majority of equity programs include two to three equity vehicles and where performance-vested stock options are highly uncommon.

The design of the long-term incentive (LTI) plan is one element of the executive compensation program that will need immediate study for a few reasons:

- A program that is heavily weighted with time-vested restricted stock or a program that only has time-vested restricted stock and stock options will be criticized by proxy advisory firms. These designs are not considered performance-based equity programs under some proxy advisory policies.
- Performance-vested stock options are very rare since two hurdles need to be met before they gain any value: the stock price must rise and the performance condition must be met. Management teams universally deride these programs as being unmotivational since the likelihood of realizing value under this design can be substantially more difficult than more typical programs. Also, most Compensation Committees agree that other equity designs can be far more effective with motivating and rewarding executives for creating value.

There is abundant market data on long-term incentive plan prevalence and practices, best practice perspectives and summaries of proxy advisory policies on long-term incentive designs. The Committee and management team have access to the information needed to design a long-term incentive plan that will align with public company practices, be motivational and support shareholder growth objectives.

5. Investigate Board Pay

The Board of Director pay practices of a privately-held company differ substantially from public company practices in several ways. In general, venture-backed private company Boards typically include individuals who are employees of the major investors and they may or may not be paid as a Board member. The Board may also include executives with substantial operating experience, financial expertise or other high-level management skills needed at the Board level. These are always paid positions.

For private companies, the Board pay mix will be heavily weighted with equity while cash compensation will be modest when compared to public company practices. The chart below illustrates the differences. This chart compares median Board pay at private companies with $25M to $50M in revenue to public companies with revenues ranging between $50M to $500M. The public company data includes larger companies to illustrate how Board pay will need to change over time once a company becomes public and grows.

Private Company	Public Company
$24,000 – Annual cash compensation:	$51,800* – Annual cash compensation
$621,836 – Total value of equity granted during the term of Board tenure	$55,000 – Annual equal grant value

*Cash compensation at the median is 51% of total pay which is $101,484.

This data shows how varied Board pay practices can be in private companies vs. public companies. At private companies, cash compensation may be less than half of public company practices. However, the value of equity may be many times more valuable. In addition, private companies typically do not grant equity each year which is a common practice at public companies.

Board pay is a topic that should be reviewed before a company goes public, especially as Board members, who represent the major institutional investors, rotate off the Board. The company will need to maintain a Board pay program that is attractive to new Directors and it will need to be fully competitive as companies vie for talent in this arena.

6. Study Proxy Advisory, Compliance & Disclosure

Private company Compensation Committees have much less concern than do public companies about proxy advisory firm policies on compensation. Additionally, public company pay practices may simply not be important to private company Compensation Committees. Therefore, it is likely a private company will have pay practices that are not common in public company practices and/or may not be aligned with proxy advisory policies. Because of the influence of advisory firms, it is always important to audit a private company's executive compensation program to understand how it differs from public company practices and to understand if any changes need to be made over time. For example:

- Private companies favor the use of stock options and restricted stock while public companies are more likely to include performance-vested equity in their long-term incentive programs especially given proxy advisory policies covering equity practices. Proxy advisory firms want to see a significant part of the long-term incentive grant made with performance-vested vehicles and often do not consider either restricted stock or stock options to be performance-based. Understanding if the design needs to be modified and the future timing of any change is important as the exit event takes shape.

- Many public companies have Section 162m umbrella plans that allow them to minimize or eliminate the lost tax deduction for non-performance based pay. This law does not apply to private companies and it is another aspect of executive compensation that should be understood and addressed in the plan design.
- Public companies need to prepare an annual CD&A as a part of the proxy statement. The CD&A needs to discuss, among many items, how pay decisions were made including disclosing in some detail incentive plan goals and performance against goals. If discretion is used in assessing performance, the CD&A needs to state the discretionary factors taken into account in determining award levels. Private companies have no similar disclosure obligation and can liberally use internal judgment on pay decisions without having to outline goals, performance attainment against goals and how discretion was used.

In Summary

Many aspects of executive and Board compensation differ when contrasting public and private company practices. As private companies near an IPO, they should consider conducting an audit of all elements of their pay practices to understand what has to change, what may need to change, and over what period of time. It is important for Compensation Committees to understand that pay programs can evolve over a two- to three-year period post-IPO, which gives the Committee enough time, with careful planning, to seamlessly evolve the program from private company practices to the best practices of public companies.

About the Author

Pete Lupo is the president of executive compensation and leads the executive and broad-based compensation consulting practices at Pearl Meyer. In this role, Pete works closely with the firm's senior leaders helping clients build innovative compensation programs that retain, motivate, and reward senior leaders and employees. Pete has worked extensively with compensation committees and management teams on a variety of strategic needs including the development of total compensation programs for the senior leadership team, aligning pay to performance, designing annual and long-term incentive plans, developing board of director pay programs, and advising on change-in-control, executive benefits, perquisites, and governance-related matters.

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