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Rethinking Pre-IPO Equity Compensation Decisions



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As we eagerly anticipate an uptick in IPO activity going into 2024, pre-IPO companies have an opportunity to reflect on the last spike in public offerings and have their own “Jerry Maguire moment”—a realization that there is a better way forward. Although 2021 was a banner year for IPOs, most companies that debuted at that time are trading significantly below their public offering price. This underperformance has resulted in boards struggling with staying accountable to shareholders and keeping employees engaged.

As private companies await the opening of the window to go public, their boards can act early to lay a strong foundation by engaging in a transparent dialogue with management teams around three core issues.

1. Sizing IPO Equity Grants

The 2021 IPO market saw many companies issuing very large equity grants (three to six times (or more) than a market-median equity grant) to senior executives. Determining the size of these awards was often based on solid reasoning: equity holdings (particularly unvested) were not on par with executives at similar-sized companies. Executives at private equity-backed companies, as well as long-tenured executives, were likely to receive a significant payday shortly following the IPO due to low strike prices and/or significant number of vested shares. There was a desire to replicate the earning potential of the pre-IPO equity awards to demonstrate to incoming shareholders that the team was “in it to win it.”

In hindsight, was it the right approach to issue these large equity grants, often with back-loaded vesting, or would we have been better off with a more modest program, such as one calibrated to the company’s annual grant value philosophy?

The underlying logic behind large IPO equity grants is that they will retain and engage a management team as their previously granted equity vests and delivers liquidity. However, the lesson learned from 2021 is that these large equity grants create significant risk for a company because they are highly dilutive and when underwater, a management

expectation surfaces that a similarly sized grant is needed to replicate that “promised value.” A mere normal-course, market-derived annual grant will likely not do, given this would be on the heels of an outsized, albeit non-performing, equity grant.

What should a board do? I would suggest the more modest annual grant approach at the time of IPO. This grant doesn’t need to be at the market median, but it should be well below the multiples we experienced in 2021. Here is some guidance:

- Boards should ensure that executives have meaningful equity ownership to demonstrate alignment with shareholders. However, immediately bridging an equity ownership gap at the time of IPO does not account for the nuances of different ownership structures and how diluted the management team needed to become to get to the point of an IPO. Instead, companies may want to look at the annual share usage amongst their peers (as well as the broader industry) and establish an IPO share usage between the 50th and 75th percentiles. If the determined amount is within this range, but higher than the go-forward equity philosophy, the intent would be to return to the philosophy for the subsequent annual grants.
- A smaller grant that does not match the magnitude of the liquidity an individual may experience is likely to create the risk that an executive departs at IPO, or shortly after, as they achieve liquidity. However, the smaller grant initially allows for more flexibility in the future if the IPO did not perform and additional equity grants at below the IPO price are needed.
- This strategy will likely resonate well internally with broad-based employees as they compare their grant amounts to executives.

I always think back to a comment made by a compensation committee chair, who also was a private equity portfolio manager: “I’ve been part of many transactions, those that have delivered ‘retirement-level money’ to executives and those that have delivered significantly less. It’s never about the quantum of dollars realized, it’s about their desire to be part of the go-forward organization.”

2. Types of Equity Vehicles

Of the companies that granted equity at the time of IPO in 2021, the majority issued stock options or a mixture of stock options and restricted stock. Today, the stock options are significantly underwater and the value of the restricted stock is severely depressed. The IPO equity grant that was intended to engage executives no longer has that power.

How can we improve on this model, understanding fully that stock price volatility cannot be predicted? One way forward is in contrast to something I have advised doing for a long time. For years, I have counseled clients against adopting performance-vested equity until the company is two to three years from their public offering, as simultaneously forecasting goals three years out (approximately 80 percent or more of all performance-share unit programs have three performance periods) and being newly public can be quite the

challenge. Upon further examination of this premise, a few observations come to mind:

- Private companies engage in strategic planning and forecast multi-year goals. For the PE-backed companies, the equity programs almost always include a performance vesting component. Having accountability regarding performance goals will not be a foreign concept to the management team.
- Performance periods do not need to be three years long. If forecasting a three-year performance goal at the time of IPO is too problematic, truncate the period to two years or even to one year. Shareholders will welcome the adoption of performance-vested equity; the shorter period signals that the company will look to elongate that forecasting ability as it matures.
- If retention is a concern, additional vesting beyond the end of the performance period to align to a typical three-year cliff structure can be incorporated into the design.
- With some portion of the award being issued as performance-vested equity, executives are held accountable for underlying performance and what was communicated in their IPO roadshow, which can serve as a hedge against a volatile equity market.

3. Leadership Assessment

The last crucial lesson from 2021 is the difficult reality that not all executives are able to effectively run and function within a public corporation. Individuals, often founders, who may have excelled in the private company realm could struggle under a very different ownership model. It is critical that a board undergoes a thorough evaluation of its go-public management team prior to the offering.

Many private equity investors conduct a leadership evaluation during the diligence phase prior to acquiring a portfolio company. Directors who have a fiduciary responsibility to the incoming shareholders need to do the same when a company transitions from private to public. There is likely no greater risk to the organization. The purpose of the assessment is not to replace key team members, but to understand where the areas of development lie, develop a plan accordingly, and identify succession candidates and ideal go-forward profiles for future leaders.

The new wave of IPOs will have a good amount of baggage to remove based on the lackluster performance of the class of 2021 and subsequent offerings. However, today’s private boards expecting to go public have an opportunity to learn from 2021. Those that question entrenched assumptions will be better equipped to guide organizations on their journey toward profitable growth and value creation.

About the Author

Aalap specializes in executive compensation strategy—governance, pay-for-performance, and incentives—helping companies align business, people, and compensation strategy for effective programs.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.