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Competing on Compensation as a Private Company

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Compared with their public company peers, private company CEOs enjoy far greater flexibility in executive compensation program design. At the same time, freedom from restrictive regulations and disclosure requirements comes with a flip side: lack of access to the power of publicly traded equity-based pay as a recruitment and retention tool.

The need to address that gap when competing for talent is leading many private companies to explore changes to their compensation practices in order to compete more effectively in the talent market. Ed Steinhoff, a managing director at Pearl Meyer, told executives gathered for a recent roundtable discussion co-hosted by Chief Executive Group and Pearl Meyer that one increasingly common practice is to combat the allure of the stock option-based incentive plans commonly offered by publicly traded companies by introducing a private-company alternative.

“How to make sure you’re able to compete with public companies with that more limited set of tools is very top-of-mind for a lot of organizations,” he explained. “At the end of the day, you want to be able to align a significant portion of executive pay with the future performance of the organization over a multi-year time period. And you also want to align executive pay with how the owners are receiving value from the organization. So, long-term incentive plans will be much more prevalent at private companies of all types, shapes, and sizes going forward than we have seen in the past.”

Leveraging LTIPs

Recent market volatility is another factor fueling interest in long-term incentive programs (LTIP) among privately held firms. “There’s been some pullback in terms of private equity work, and exit events are bleeding longer than their anticipated timelines,” noted Ryan Hourihan, a managing director at Pearl Meyer. “In those instances, individuals who received lump sum grants at the front end of an engagement and are now largely vested can leave with that vested equity. This puts a strain on the organizations in terms of incentivizing those executives to stay on until the company reaches that exit event.”

Even nonprofit organizations are diving into long-term incentive pay compensation. Research institute RTI International is among the growing number of organizations that chose to introduce an LTIP in recent years. The non-profit bases its program’s awards on two components, margin and revenue, weighted at 25 percent and 75 percent respectively, and gives its compensation committee discretion to make adjustments for additional factors, such as S&P rating or balance sheet strength, said CEO Tim Gabel.

“We’re a mission-driven organization, so it’s interesting for our board to think through how to compete for talent,” he said. “We’ve done things like sign-on bonuses that recognize what new hires might be leaving behind, and we’ve tended to be higher on base pay, knowing that we’re relatively low on short- and long-term incentive pay. We also try to present it to people as, ‘Your total comp may be lower than what you’ve been experiencing, but less of your compensation is at risk.’”

It’s an argument that resonates with today’s younger-generation employees, several roundtable participants reported. “Some of these young hires don’t look at total cash; they just look at what’s guaranteed,” said Ronald Tomaszewski, CHRO at Butterball.

“There’s hypersensitivity and speed around everything now,” agreed Michael Lagrossi, co-founder of Blue Bear Protection and a venture partner at Capital States Ventures. “A lot of people aren’t interested in a four-year vesting period anymore. That’s almost a thing of the past. They want a grant, and they want to vest in maybe two years. There are some who will be jazzed about long-term incentives, but it’s not one-size fits-all.”

Value Visibility

While different employees will have different priorities, robust communication about how a compensation plan plays out over time is critical to ensuring that each employee understands the value of the various components of a company’s program. “You can’t over-communicate the value of programs,” says Steinhoff. “A base salary is very straightforward, but whether you’re talking about a short-term incentive plan, a long-term incentive plan, an ESOP or retirement benefits, the more you communicate—the more transparent you are about the potential value of the programs—the better off you’ll be.”

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The Judge Group, a business technology consultancy where approximately 65 percent of the company’s workforce is under age 30, initially struggled getting an employee base that tended to prioritize fixed compensation to appreciate the value of incentive pay. “Hard cash in hand, that’s what they look for,” said Abhishek Agarwal, president of The Judge Group. “We encountered a lot of challenges explaining [long-term incentive pay] to these young people… We’ve had to create a system that makes it more visible to them that, ‘if you do this, you will get this.’ We tell them, ‘This is how the company gets valued, and that’s how you will get more rewards.’”

A lack of transparency about finances is one of the barriers private companies often face in successfully implementing incentive pay tied to financial performance. Closely held family companies, in particular, often shy away from sharing the value of the organization, which can make it difficult to entice talent with incentive pay tied to company performance. “You can’t really put an LTIP in place that rewards employees for value creation when you aren’t willing to disclose value,” said Steinhoff, who added that companies recruiting talent can work around the issue by quantifying the potential worth of the incentives over time. “For example, you can give potential hires scenarios, ‘If you’re making $100,000, this much is going into the plan, and in 10 years it will be worth X. In 20 years, it will be worth Y.’ And, ‘The LTIP is designed so that if we hit target, you’ll get X; if we hit maximum, you will get Y.’ Giving them tangible information about the dollars is how you make it more real.”

For current employees, compensation communications should be ongoing and frequent. Private companies can exploit the advantage they have of being able to share more information with their employees, noted Julia Stewart, founder of Alurx and the former CEO of Dine Brands, operator of Applebee's and IHOP restaurants. "I have chaired talent and compensation for both private equity-owned and public companies, and the biggest difference I see is that you can communicate more freely and often when you're private," she said. "At a public company, I can't talk every quarter to thousands of employees about how we're doing. In the private sector, being owned by a private equity company or an ESOP allows you to communicate—and communication is the most effective tool you have to get traction."

For companies that conduct external evaluations, Steinhoff recommends sharing what a participant's awards are currently worth—the in-the-money value of the awards, and the vesting time horizon—on an annual basis. "Whenever a client with a well-structured LTIP says, 'We're not getting the value out of these programs,' nine times out of 10 it's due to lack of communication," he said.

Mitchell Martin Founder and CEO Gene Holtzman recognized the importance of robust communications when he decided to transfer an ownership stake in his technology and healthcare staffing company to employees through an ESOP. Because selling 40 percent of the 39-year-old company to a group of longtime employees was a more complicated transaction than selling it outright or transferring ownership to his son, employees needed to understand and appreciate the potential value to stay on through the nearly two-year deal process. "They're not going to see real numbers until about year four, five and six, so we hired a communication company and rah-rahed it," explained Holtzman, who noted that the time-consuming and costly endeavor was ultimately a win-win for him and his team. "There is very strong potential that in five, six, or seven years, there can be hundreds of thousands of dollars in each person's ESOP."

While retaining current employees through an ownership stake transfer can be challenging, privately owned companies more often face recruiting challenges due to a candidate's concern about a change in ownership down the road, noted Fred Engelfried, president of Market Sense. "As a candidate looking at an owner who might be in his late 60s, you ask yourself, 'What happens if this person has a heart attack or decides to sell the business?'" he said. "Insecurities like that can be overcome with things like a change-of-control agreement after a certain number of years of service and a termination agreement that gets sweeter over time."

A Private Edge

Private companies should also consider identifying and emphasizing non-compensation-related advantages in their recruiting and retention efforts. Establishing work/life balance, a purpose-driven culture, career advancement opportunities, benefit packages, and other factors as points of differentiation can promote or reinforce a company's employee value proposition.

"Typically, not-for-profits have pretty rich benefit plans, whether it's a medical plan with no copays or no deductibles, more lucrative paid time off benefits, sometimes more lucrative retirement benefits," said Steinhoff. "So, when you put the different pieces together, including maybe a cash LTIP and a generous ESOP, the composition of the package might be little bit different, but we can get quite a bit of the way there to match what you would see at a similarly sized public company."

Recent market volatility coupled with turbulence in the tech sector have also opened a door for making the case that private company incentive programs tied to metrics other than equity prices may actually be more lucrative for employees than stock options. "There's been some movement toward utilizing more strategic initiatives or softer metrics in executive bonus design," noted Hourihan, who added that younger-generation employees are less comfortable with the uncertainty of incentives tied to financials. "They tend to want more tangibility around cash compensation."

Private companies might want to highlight the "Lotto ticket" nature of equity-based incentives to potential recruits, agreed Seth Boyarsky, vice president of compensation at *Forbes*, who said employees often sour on options after their packages fail to pan out. "At most of the acquisitions we did when I worked at iCIMS, the equity was under water," he recalled. "People at the companies being acquired would all say that their experience working at tech companies was that the equity wasn't really worth anything at the end of the game. When people talk about wanting equity, they don't realize it doesn't always mean you will get something."

Ultimately, getting compensation program design right hinges on developing a plan tailored to the company's specific circumstances and talent needs. "The right data source can provide some insight" said Steinhoff. "How do your employees feel about the current compensation? Who do you compete with for talent? Who do you lose people to? All of that is what will drive determining the most appropriate survey sources to use to reflect that market for talent and, beyond that, where you want to position yourself relative to the market data."

"The market data is the starting point, not the answer," he added. "It gives you external context within which you can make decisions that are right for your organization. We always say that compensation is part art, part science. It is actually more art than science in a lot of ways because you apply that data to your own unique situation. There's a lot of judgement involved."

About the Authors

Ed Steinhoff is a managing director and consulting team leader at Pearl Meyer. In his management role, he oversees a team of senior compensation consultants in the execution of the firm's growth strategy and in the development of consultants at various stages in their careers. With more than 25 years' experience in executive compensation, Ed works with the boards of directors and senior management teams of public and private companies, ranging from small and middle-market firms to multibillion-dollar corporations, to design pay programs that drive business performance and value creation, secure high-performing executive talent, and meet both regulatory standards and stakeholder expectations.

Ryan Hourihan is a managing director with Pearl Meyer. He has over ten years of experience advising boards and senior management on incentive compensation design, corporate governance, and performance measurement with the objective of supporting business strategy, value creation, and shareholder interests. Ryan is particularly experienced in compensation challenges unique to privately held firms seeking to compete with publicly traded firms. His clients have included Fortune 500 organizations, privately held companies, and pre-IPO ventures across an array of industries.

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.