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Trends and Opportunities in Private Company Executive Compensation



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An expert Q&A with Aalap Shah, managing director at Pearl Meyer, on trends in private company executive compensation. In a conversation with Practical Law's *Jessica Cherry, Aalap addresses the primary differences between public company and private company compensation, strategies for adapting compensation programs in a volatile environment, compensation design trends, best practices and opportunities that exist for private companies to gain a competitive advantage, and more.*

When it comes to using compensation to attract, retain, and engage talent, most perceive public companies as having a significant competitive advantage over private companies, primarily because of their ability to issue stock that can be readily traded through a public securities exchange. Employees who receive public company equity awards, such as stock options, restricted stock units (RSUs), or performance shares, receive a tangible benefit. Because the underlying stock is traded on an exchange, it is relatively easy for the holder to determine the value of their award, and when they will have shares to sell. By contrast, employees who receive private company equity awards may have a difficult time ascertaining the precise value of their award and when, or if, a liquidity event, which may be a prerequisite to realizing any material value, will occur. While private company equity awards can have a greater upside, there is also greater risk, which can be exacerbated in a volatile market, where timelines to liquidity can be difficult to predict and much longer than anticipated.

But private companies competing for talent also have some advantages. Whereas public companies must comply with a host of constricting regulations and provide detailed disclosure regarding their compensation programs that are heavily scrutinized by a broad swath of stakeholders, private companies are less constrained. This freedom from restrictive rules and extensive disclosure requirements, combined with a smaller, and typically more manageable shareholder base, and in many cases closer working relationships with their boards of directors, create an opportunity for private companies to

design compensation programs that:

- Create future value;
- Are narrowly tailored to the specific needs of the company;
- Can be readily adjusted as market conditions and business priorities change; and
- Engage and motivate the company's employee population.

Jessica Cherry of *Practical Law* asked Aalap Shah, managing director at Pearl Meyer, to address:

- Differences between public company and private company compensation;
- How companies should approach making compensation adjustments in connection with an initial public offering (IPO);
- Compensation differences across industries;
- Recent changes in the private company compensation landscape and how companies have adapted their compensation programs; and
- Best practices and opportunities that exist for private companies to gain a competitive advantage.

Do compensation levels differ between public versus private companies?

Aalap: As a rule of thumb, there is a 20% discount between public company and private company compensation, meaning that certain private company employees receive about 20% less total target compensation than their peers in comparable roles at public companies. Most of the difference in value is due to the greater prevalence of long-term equity incentive compensation at public companies.

This delta exists primarily at the senior executive level (generally the chief executive officer (CEO), chief financial officer (CFO), general counsel (GC) and chief human resources officer (CHRO)), where the roles at public companies are often more complex. Consider, for example, that at public companies, among other responsibilities:

- CEOs lead investor calls, they must effectively communicate the company's strategic vision, answer to a large number of shareholders, and are subject to significant public scrutiny by shareholders, the media, and other stakeholders.
- CFOs oversee compliance with myriad regulations and reporting requirements.
- Both CEOs and CFOs must certify that the company's financial statements and disclosures fairly present the operations and financial condition of the company.
- GCs and CHROs are generally part of the executive management team and are responsible for ensuring that the company is adhering to public company governance standards.

These are weighty responsibilities that justify the compensation differential.

When you look deeper into an organization, however, parallel roles at public versus private companies may not be vastly different. A vice president of marketing, for example, may have similar responsibilities across a broad spectrum of companies, regardless of whether the company is public or private. Accordingly, at levels below the top of the house, a lot depends on the company's compensation philosophy and the responsibilities assigned to each role within the organization.

How should companies that are transitioning from private to public approach compensation adjustments?

Aalap: Companies should not over-rely on any rule-of-thumb or conventional guideposts. In 2021, when there was a robust IPO market, directors and management teams of companies that were transitioning from private to public grappled with how to adjust compensation. Many contemplated whether to implement pay increases across the entire organization, and if so, whether those increases needed to be uniform. Most ultimately determined that across-the-board increases did not logically make sense. Rather, they concluded a more sensible approach was to consider how much each role would expand or evolve in connection with the transition, and take into account that information, along with other factors.

With the IPO market currently on the upswing, companies with IPOs on the horizon should ensure that those setting compensation:

- Carefully evaluate what actual changes in responsibilities will occur in connection with the transition from private to public.
- Consider what development needs may be required to address the changes in responsibilities and formulate a human capital plan that paves the way to achieving them.
- Familiarize themselves with market compensation for the company's peer group and sector.
- Consider pay equity and internal fairness.
- Make thoughtful compensation adjustments that:
    - Align with the company's compensation philosophy and transition strategy;
    - Reflect actual changes in responsibilities; and
    - Are not too far afield from the market.

How do private company compensation elements compare to public company elements?

Aalap: In general, the elements of private company compensation have increasingly fallen in line with public companies. Private companies typically provide:

- Base salary.
- Short-term cash incentive compensation (typically annual bonuses).
- In the case of large private companies and private equity-backed private companies (PE companies), long-term cash and equity incentive compensation (typically limited to the vice president level and above).
- Benefits and employee support.

Base salary and short-term cash incentive compensation are clear-cut and may not differ substantially between public and private companies. One caveat is that at PE companies, base salaries are typically at or slightly below market, with the lion's share of compensation coming from the incentive programs, which generally include cash bonuses and equity awards. There is potential for a much bigger upside, but less compensation that is guaranteed.

Long-term cash incentive programs (followed by stock option grants), are widespread at non-PE private companies. A typical private company design includes the following features:

- Participants are granted a target award, which may be adjusted up or down based on performance against preestablished performance objectives.
- Performance is measured over a three-year performance period.
- From a performance perspective, participants are fully vested at the end of the three-year performance period.
- The payout schedule may be either:
    - Lump sum payment of the full amount at the end of the three-year period; or
    - A stream of payments, with the first installment paid at the end of the three-year cycle, and additional installments paid at the end of the fourth and fifth years, respectively, subject to the participant's continued employment.

Practically speaking, where all or a portion of the payment is extended out for two years following vesting, this essentially transforms the three-year vesting cycle into a five-year cycle (and in some cases the payout schedule is even longer) since the participant is subject to a continued service requirement and does not receive significant value until amounts are paid. The payment streams are:

- An effective tool for spreading out the participant's income tax obligation.
- A meaningful retention device.

To ensure that the incentive is meaningful, companies must carefully consider:

- The quantum of long-term compensation.
- The payout schedule.
- The interrelationship of the two.

(The payment schedule must be set up properly in advance so as not to run afoul of Section 409A's rules for payment of nonqualified deferred compensation. For information on Section 409A, see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview.*)

Some companies have experimented with even longer payment streams. For example, one company set up a program with vesting over four years and then payment over a four-year period after that. They called it "four years in and four years out." Pearl Meyer was engaged to modify that program, because people were understandably frustrated at having to wait eight years before receiving any material value. This company eventually migrated to a five-year program, with a three-year vesting schedule, and payout two years after that, which everyone was much more comfortable with.

In addition to cash incentive compensation, most private companies today implement some form of long-term equity incentive plan. These plans present certain design challenges due to:

- The lack of a public market for the shares.
- In many cases, the need to retain certain key employees until a liquidity event (such as an IPO or a sale) occurs.

Private companies grant a myriad of equity award types, with stock options being the most prevalent, followed by RSUs, and phantom equity. Equity awards typically vest over four years, which aligns with public company market practice.

Non-PE private companies primarily grant equity awards that time-vest, which they may or may not supplement with additional equity awards that vest based on the achievement of performance goals. This is in contrast to public companies and PE companies, where the philosophy is to typically strike a balance between time and performance vesting.

Some PE companies may provide outsized equity opportunities (which often include profits interests) that surpass what you see at public companies. But the comparison is not apples to apples, as in the PE company context:

- Much of the long-term incentive compensation is front-loaded (whereas public companies typically make annual grants).
- No significant value is realized until:
    - A liquidity event, such as a strategic sale to another PE entity or an IPO, occurs; and
    - In many cases, achievement of a performance hurdle, based on achievement of a certain minimum multiple on invested capital (MOIC) or money-on-money (MoM) return, and/or a minimum rate of internal return on investment (IRR) realized by the private equity fund through the date of the liquidity event.

Does private company compensation vary depending on industry?

Aalap: In general, there are not significant differences in the types of equity compensation used across industries. The primary distinction is between high-growth-oriented tech and life sciences companies and everyone else. In tech and life sciences, the entire employee population, even employees at the most junior level, are accustomed to receiving equity as part of their compensation package. This is in contrast to other sectors where equity is generally provided only at the executive levels. This distinction is crucial for private companies to be aware of when structuring their offerings.

While there are many benefits to granting equity deep into the organization the challenge for these high-growth companies is how to compete with public companies, especially when trying to pay with cash, which can be a formidable challenge, especially for a nascent company.

High-growth companies need talent that is focused less on the here and now, and more on executing for the future. They should therefore consider changing the compensation narrative from “this is what your compensation is today” to “here is what you may have the ability to earn in the future if you engage in building this company.” A few strategies high-growth companies can employ to shift mindsets, improve the wealth creation narrative, and drive engagement are:

- Ensuring that the company’s recruitment strategy reflects this forward-looking approach.
- Creating individualized compensation statements that set out the potential long-term value of equity compensation.
- Taking a cue from public companies and making more frequent equity grants (such as every two years), as opposed to the usual practice of making at-hire grants, followed by ad hoc grants on an as-needed basis.

How has the private company landscape changed in recent years and how have private companies adapted?

Aalap: There was a significant cooling of IPO and M&A activity the past few years. While things are warming now, the market is still uncertain, and just as companies must be prepared to adapt their business strategies when unexpected things happen, the same is true with respect to compensation.

During the downturn, liquidity events that were expected to occur within five years in many cases did not occur for seven or eight years, or in some cases took even longer. This diminished the motivating and retention value of outstanding awards, putting pressure on compensation. To continue to get value from their compensation programs, companies had

to be creative.

Some large private companies, particularly in the tech space, created mechanisms for providing liquidity before a liquidity event occurred through:

- Internal exchange programs, where employees who wanted to sell their equity could connect with others within the company who wanted to buy shares (subject to a 2,000 shareholders limit to stay private under Section 12(g) of the Securities Exchange Act).
- Company buyback programs, often subject to a restriction on sales equal to a certain percentage of vested holdings (typically somewhere between 10% to 50%).
- Financing events, where employees could sell their shares to an incoming investor. Similar to buybacks, to ensure that the remaining equity continued to serve as an engagement and retention mechanism, companies tended to allow employees to sell only a percentage of their holdings.
- Programs set up with third party purchasers.

Other companies took different approaches. One company decided to calibrate compensation to the market by increasing base salaries and bonuses (essentially taking the outstanding equity out of the equation). While I understand the logic of this strategy, I do not recommend it. The obvious problem here is that the company is sending additional cash out the door every year regardless of performance, raising questions about:

- How to hold management accountable.
- Whether the increased cash compensation is creating any real value.

Complicating things further, this company eventually went public, and therefore became subject to the Securities and Exchange Commission's (SEC's) expansive executive compensation disclosure rules and additional stakeholder scrutiny about their compensation practices. This raised concerns that the cash compensation would be perceived as "excessive" by proxy advisors and others. We have therefore spent the past three years unwinding that cash heavy program and migrating to a more market-based, balanced approach. The program is finally at a place that makes sense for the company, but it took some time, and it was not without some fallout. Not surprisingly, some individuals left the company, as no one likes to be told that their pay is above market and that they will not get a base salary increase, especially in times of rampant inflation.

Another PE company revisited its compensation program after holding an investment for approximately ten years. The company initially implemented an equity program with a four-year vesting schedule. When that cycle ended, they ran the same program again, although the CEO and the board of directors were still unsure of when an exit event would be appropriate. While the participants were initially very enthusiastic about the projected value of their equity, over time, as they found themselves vested or almost vested in equity that, due to circumstances beyond their control, had no tangible value, their enthusiasm waned. The company became increasingly worried that people would start considering other opportunities. They realized that they needed to take action to engage and motivate

people.

We created a new program with the following design features:

- We implemented an all-cash program that ran parallel to the existing equity programs.
- Performance was measured over a two-year performance period.
- The program included financial and operational performance metrics that were not tied to an exit event.

Significantly, this cash program supplemented, rather than replaced, the company's existing equity programs. It was therefore still possible that an exit event would occur, triggering payout under the existing programs before the new two-year performance period ended. But regardless of the timing of the exit event, participants knew that if the performance goals established under the cash plan were met, they would receive a benefit. So the new program created a tangible reward that could serve as a bridge to an exit event.

Of course the use of cash instead of equity goes against mainstream practices, as equity is widely regarded as the most effective tool for:

- Creating value.
- Aligning the interests of management with the interest of investors.

But in situations where significant time has passed, equity has already been issued, and there is still no surety that a liquidity event will occur anytime soon, engaging and retaining hard-working employees requires companies to consider creative solutions.

Also, when times are uncertain and employees may be questioning whether they will ever realize any value from their awards, it is crucial for companies to provide robust and frequent communications regarding the status of the company's compensation programs, any adjustments the company is making, and the value of awards. A robust communication strategy is:

- A key component in managing the risk created by uncertainty.
- Oftentimes neglected, and then poorly executed because it is considered only as an afterthought.

Once a company realizes that the time until a liquidity event is going to be elongated, when should they make changes to their compensation program?

Aalap: Despite knowing that a liquidity event will not occur in the originally anticipated timeframe, most companies take no action until the applicable performance cycle is over and individuals are fully vested. Only then do they contemplate next steps. There are several disadvantages to this reactive approach, including:

- The value of retention awards has already declined once individuals realize that an exit event is not on the horizon.
- Rushed decision-making and sloppy communications.
- An adversarial posture between management and the board which can result in bigger payouts (due to greater expectations since individuals are largely vested).

A better approach is for the company to proactively evaluate where things stand and be prepared to make adjustments about midway through each performance or investment cycle, when the company has ample time to thoughtfully reflect on what program changes are appropriate.

Consider that by making new equity grants every year, public companies build retention value on top of the value that already exists from prior grants. While private companies do not typically need to conduct an evaluation or make adjustments every year, in an uncertain market, these companies should consider taking a look at where things stand every other year, or midway through each performance cycle.

Does being subject to less scrutiny and less regulation than public companies create opportunities for private companies to gain a competitive advantage? How can private companies leverage these opportunities?

Aalap: There are a host of ways that private companies can leverage their flexibility to create competitive advantage, including:

- Adopting non-financial performance metrics that create future value.
- Being creative and thinking holistically about benefits and employee support.
- Expanding incentive plan participation.
- Cultivating and leveraging board relationships.

Adopt Non-Financial Performance Metrics That Create Future Value

Public company incentive plan metrics are typically heavily weighted toward traditional financial performance measures such as:

- Total shareholder return (TSR).
- EBITDA.
- Earnings per share (EPS).
- Net revenue.

These traditional financial metrics (which may be absolute or relative), are viewed favorably by shareholders because of the perceived alignment between their own interests and those of management. While some public companies, particularly those in certain industries, now incorporate non-financial metrics into their incentive compensation programs, such as metrics that are tied to human capital and other environmental, social, and governance (ESG)-related outcomes, companies that do so generally assign them an aggregate weight of perhaps 20-30%, compared to the 70%-80% weight assigned to financial measures. Or they may determine bonus amounts based on financial performance, subject to an ESG modifier, which authorizes the plan administrator or the board to adjust bonus payouts up or down by up to 10% based on ESG achievements.

Because they are beholden to a much smaller group of shareholders, are not required to discuss financial performance on quarterly investor calls, and are generally subject to less scrutiny, private companies have much more flexibility to select performance metrics that are:

- Holistic (meaning that they create value in various ways above and beyond short-term financial gains).
- Forward-looking (for example, metrics that are based on strategic milestones, key initiatives, the product pipeline or employee engagement, as opposed to financial metrics that are inherently backward-looking).
- Aligned with the company's culture and values.
- Designed to ignite an innovation mindset.

Private companies are therefore in a position to move the needle on issues that they care about, and that their employees care about, without much external scrutiny. For companies that are not well-known and therefore struggle to attract talent, this can significantly aid recruiting. Consider that younger workers today are increasingly seeking meaning and purpose from their work. Companies that can demonstrate an authentic commitment to their values through their compensation programs are better positioned to attract this demographic.

Some foundational questions companies should consider asking when selecting appropriate metrics are:

- What do we want our company to look like in three years? In five years?
- Who should our future leaders be and how can we use compensation design to engage and retain them?
- What new products must we develop to remain competitive?
- How can we make our processes more efficient?

These questions prompt the company to consider matters that will have a profound impact on the company's future.

Private companies should consider a wide array of performance measures, both quantifiable and subjective, that may be tied to, among other things:

- Product innovation, such as developing the company's product pipeline, for example, by developing two to three new products every year.
- Cross-team collaboration, such as the head of a division effectively collaborating with other parts of the business.
- Leadership development, such as:
  - Participating in leadership trainings;
  - Improving leadership skills as measured by team feedback surveys; or
  - Identifying and investing in the development of future leaders.
- Succession planning, such as:
  - Creating development plans for CEO and broader executive team succession planning;
  - Formulating a skills matrix that maps to the company's three-to-five-year business plan and informs the company's human capital strategy; and
  - Identifying CEO candidates in the years leading up to the current CEO's retirement.
- ESG-related outcomes, such as:
  - For an airline, transitioning manufacturing processes to non-carbon-based energy sources;
  - For a healthcare company, improving community health; or
  - For a company that is committed to racial justice, forming a new partnership with a community-based organization that protects voting rights.

Private companies can also be nimbler. For example, they can establish metrics that are narrowly tailored to one area, such as succession planning, assign a high weight to it at a particular time, and then quickly pivot to something else as priorities change, without worrying about external perceptions.

Be Creative and Think Holistically About Benefits and Employee Support

Private companies can also differentiate themselves by being nimble regarding the types of benefits and employee support they provide. For example, some private companies offer:

- 100% employer-paid health plan coverage.
- Greater mental health benefits and coverage.
- Financial counseling services (sometimes provided in connection with a broad-based equity compensation program, which can be very meaningful for employees who may be receiving equity for the first time).
- Greater work-life balance and flexibility regarding the ratio of in-office versus hybrid and remote working.

- Significant and customized career advancement opportunities.

These benefits are meaningful as they communicate that the company is interested in the health and well-being of employees, both at work, and in the broader context of their full lives.

Expand Incentive Plan Participation

To increase employee motivation and reduce employee attrition, private companies should consider expanding incentive plan participation to include all employees. Across industries, it is often a missed opportunity to restrict incentive plan participation to senior executives. By reaching deep within the organization, potentially covering all employees, the company gives individuals who create value every day the opportunity to participate in, and feel connected to, the company's sustainable long-term value creation strategy. While not appropriate for all organizations, private companies that have a thorough understanding of their company's culture and values are well-situated to determine whether this is the right approach.

In contrast, a public company proposing a broad employee ownership model would likely face significant pushback from shareholders concerned about share usage and dilution. While some of this friction does still exist within private companies, it is generally easier for private company management to have thoughtful conversations with their smaller group of investors about why this model makes sense.

Cultivate and Leverage Board Relationships

Private companies generally have more amicable working relationships with their boards of directors, which they do not always take full advantage of. While highly committed to the companies they serve, public company board members face some constraints. For example, they often must focus on:

- Making purely fiduciary-related decisions.
- Compliance matters.
- Maintaining a risk-averse posture.

Private company board members, by contrast, often have a more personal interest in the company, making them very motivated to collaborate with management and focus on what is best for the business.

This dynamic facilitates thoughtful conversations about compensation design, and potentially greater openness to:

- Defining value in a broader, more holistic way.
- Adopting forward-looking performance measures that may not yield immediate financial results but create future value.
- Developing employee benefit plans and programs that support employees both at work and in the broader context of their lives.

Private companies have long struggled to compete with public companies for talent. And they unquestionably face compensation design challenges. But private companies also have opportunities to leverage their greater flexibility and design innovative compensation programs that deliver a competitive advantage by:

- Creating significant value above and beyond short-term financial results.
- Moving the needle on issues that align with their values and that matter to their current and prospective employees.
- Attracting, engaging, and retaining talent.
- Supporting their employees both at work and beyond.

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.