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# How to Use External Compensation Advice at Different Stages of Private Company Growth

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When should investors consider outside advice for their portfolio companies' compensation plans?

Unencumbered by as much regulation and shareholder sentiment as public companies, private companies have more flexibility to use compensation as a competitive advantage and, in many cases, further align executive and investor priorities. Deploying this strategic tool at every stage of growth also provides an edge in competing for executive talent with other private companies as well as public companies.

While an early-stage private company may not need the same level of outside advice as a late-stage private or public company, there are several different ways compensation can be optimized regardless of growth stage or maturity.

**Early-stage private companies often have simply structured and straightforward compensation.** Base salaries are modest, and emphasis is on the new-hire equity award (typically stock options) and the associated upside potential. There may be no or minimal differentiation in base salaries among the leadership team and bonus plans are rare.

**Late-stage private companies typically see cash compensation increases as they have a stronger runway from capital raises and revenue growth.** Individual differentiation in base salaries and target cash compensation based on market benchmarking and the overall competitive labor market can come into play. Companies are more likely to have a bonus plan in place that is either a year-end discretionary bonus or an award with pre-established targets that are aligned with business objectives and investor expectations. Earnings before interest, taxes, depreciation, and amortization, or EBITDA, tends to be the primary short-term incentive metric and some companies include quantifiable strategic milestones.

Equity continues to be a prominent pay element, but companies at this stage will refine their equity granting strategies to develop an equity refresh program as new-hire awards approach full vesting and the need to manage dilution and burn rate grows. Many companies continue to use stock options as the primary equity vehicle, but restricted stock units (RSUs) are increasingly becoming a vehicle of choice for follow-on equity issuances and in larger companies where the upside in the stock price is more muted. Stock options for senior leadership may include a mix of time-vesting stock options and those with performance targets tied to key financial milestones or investor return on investment targets. As a company matures, it may also establish a formal compensation committee and begin to appoint outside, non-investor board members to evaluate and administer executive compensation programs.

**Companies transitioning from private to public benchmark executive base salaries, target bonuses, and equity awards similarly to public companies.** Cash compensation may be adjusted to better align with public market practices and companies likely transition to an annual grant cadence for equity awards. Companies may transition from solely granting options to granting a mix of options, RSUs, and performance shares units. Most companies will establish a formulaic bonus plan with preestablished performance targets if one is not already in place or is more discretionary in nature.

## When Private Companies Should Seek Outside Compensation Advice

Some companies only seek outside compensation advice when they are preparing for a strategic sale or upon transition to the public market. However, there are several different advisory touchpoints along the growth continuum that can be leveraged to better use compensation as a strategy to advance business priorities. Some examples of when and how to use outside advice include the following:

**Early-stage companies**

- Discuss the equity allocation strategy and management of a multiyear equity pool (e.g., sizing of the pool, deployment ratio, eligibility).
- Conduct investor due diligence (e.g., cost of the compensation program relative to market, pay-for-performance evaluation, the program's retention holding power of the executive team).

**Late-stage companies**

- Develop a compensation philosophy to ground compensation decisions.
- Formally market benchmark pay elements including base salary, target bonus, and equity awards.
- Identify the appropriate mix of equity vehicles: stock options, restricted stock, and performance awards.
- Develop base salary, target bonus, and equity guidelines.
- Seek advice on new-hire compensation offers that are attractive and market-competitive.
- Develop a bonus plan with measures and targets that are aligned with key business objectives.
- Form a compensation committee, developing the charter and annual calendar of work activities while taking advantage of ongoing independent advice and support as needed.

**Companies seeking a strategic exit or sale to a private equity investor**

- Assess compensation payout value under various exit scenarios.
- Develop retention strategies for the post-transaction period.

**Companies that are transitioning to the public company market**

- Benchmark compensation practices against a public company peer group.
- Transition the compensation philosophy and program to align with public company

practices.

- Develop a new long-term incentive grant strategy that will likely include an annual grant cadence.
- Establish the public company equity pool for future grants that also meet shareholder expectations regarding dilution.
- Refine the bonus plan to include a balanced suite of metrics that assess past performance but also lead to future value creation.
- Prepare for required public disclosures and the company's new regulatory environment.

Optimizing executive compensation programs can be useful for companies at all stages and investors are likely involved with portfolio companies across multiple stages. Those that view compensation programs as dynamic have a strategic advantage in their ability to attract, engage, and retain executives while also aligning their management teams with evolving strategic business priorities and investor expectations.

## About the Author

Jane Park is a managing director at Pearl Meyer. With nearly 20 years of experience, Jane advises public and privately-held clients on executive and non-employee director compensation issues. Her work is focused on pay governance, incentive plan design, pay-for-performance alignment, compensation benchmarking, proxy analysis, and special programs for IPO and M&A transactions.

## About Pearl Meyer