Directors & Boards

IPOs and the Executive Compensation Challenge
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According to a recent *Wall Street Journal* article, Initial Public Offerings have hit a pace not seen in years. In the first two months of this year, 42 companies went public in the U.S., tying 2007 for the busiest start to a year for IPOs since 2000.[1] And there's every reason to think that 2014 will be another strong year for IPO deals.

But successful deals don't simply happen. To attract and retain key staff during an IPO, compensation must be competitive and reflect public company levels and practices. In addition, governance and risk management protocols should be established and followed to comply with regulations and avoid controversial practices. Indeed, it can be difficult to move from very individual and idiosyncratic executive compensation programs and practices into a more transparent world of full-disclosure public company pay strategies, but that's very much a part of IPO reality.

For directors, understanding the issues in moving from private to public and planning well in advance is key to avoiding executive compensation missteps. What, then, are the crucial considerations directors must consider in structuring programs for companies planning an IPO?

For starters, directors should work with management to develop an executive compensation philosophy that will drive the design of the executive compensation programs and will be disclosed to shareholders. A philosophy statement can range in the degree of detail but typically addresses common elements such as the role of compensation in supporting business goals and objectives, the mix of fixed versus variable pay and short-term versus long-term pay, market benchmarking and competitive pay positioning, and the approach to paying for performance.

Once the philosophy is agreed to, current compensation levels can be benchmarked. Typically, a compensation peer group is used for benchmarking consisting of 10 to 20 publicly traded companies of similar industry and size.

At that point, current compensation data and information about compensation practices for nonemployee directors and executives are evaluated for market competitiveness against those of the peer group.

This may seem like a pro forma exercise, but it shouldn't be. In fact, it is critical for Directors to be involved in the process of selecting peer companies, as this has a

[1] Dealogic and Wall Street Journal, March 6, 2014 "Companies Rush to List Shares".

significant impact on the conclusions about the current compensation program and design of future programs. Furthermore, the selected peer group is disclosed to shareholders and is often a focus of their contention and fodder for executive compensation critics.

Then there's the issue of equity compensation, which the financial community and other investors see as a key way to align an executive's interests with those of management and therefore look for executives with meaningful equity ownership. Determining the right amount and type of grant can be a delicate balance of risk and reward and is based on several important factors, such as type of award and industry; the executive's roles and responsibilities and their influence on equity performance; and executive tenure relative to the IPO timetable and the related impact of pre-and post-IPO dilution levels on individual grants.

Most companies' pre-IPO awards are in the form of stock options; however, the practice varies based on industry. Recent post-IPO awards are typically in the form of a combination of restricted stock (or units) and stock options or stock options only, but mature companies tend to also use performance shares.

Pre- and post-IPO share dilution levels from equity incentive grants vary significantly by industry as well. However, median cross-industry data show that overall company pre- and post-IPO equity dilution potential is at 12 percent and 10.3 percent, respectively. Directors should pay close attention to dilution levels as it represents a potential transfer of wealth from shareholders to executives.

In addition, there are several other key factors that determine alignment of pay and performance, such as pay levels, pay mix (portion fixed vs. variable), incentive measures and goals, and discretion. Companies tend to have target, threshold, and maximum incentive performance goals (many prefer to calibrate plans so that target-level payouts are near the market median and maximum-level payouts are near or above the market 75th percentile).

While quarterly earnings per share will receive a lot of attention following the IPO, rewarding only for earnings without consideration for growth, margins, and returns may not lead to sustainable value creation.

Thus, Directors should attempt to balance risk and reward, as well as short- and long-term perspectives, understanding both the range of potential payouts and the incremental performance required to earn them, and feeling confident that the alignment of the two is justified. Much attention should be given to the performance goals as they determine the level of payout under the variable compensation plans.

Compensation agreements, plans, and policies set the boundaries within which compensation programs operate; they are disclosed to investors and must comply with securities and tax regulations for publicly traded companies. Some plan and policies for considerations are as follows.

- Employment and severance agreements
- Annual incentive and equity plan documents
- Stockownership guidelines
- Insider trading and anti-hedging policy
- Clawback policy
- Compensation Committee charter
- Compensation Committee calendar of activity

To ensure these arrangements are reasonable, both executive compensation experts and legal counsel should be involved in their development.

Throughout the complex IPO process, establishing new executive compensation programs is a priority for management and responsibility of directors. New regulations, proxy advisory firms, shareholder say-on-pay votes, disclosure requirements, and insider trading are all considerations in designing executive compensation programs for public companies. Having the right programs prepared in advance — programs that can fully withstand public scrutiny — can help mitigate risks while maximizing opportunity and value.

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