Executive Compensation: Five Considerations for an Initial Public Offering

The number of U.S. IPO deals completed in 2013 is expected to outstrip volume in any year since before the financial crisis, with average performance continuing to dominate benchmark indices.

In order 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.

Understanding the issues in moving from private to public and planning well in advance of the IPO launch is key to avoiding executive compensation missteps. This article explores five critical areas to help organizations structure programs for a smooth public exit.

I. Pay philosophy and levels

An executive compensation philosophy drives the design of programs, reflecting how they will be disclosed in the IPO registration statement and subsequent annual proxy statements. It includes 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 approved and formalized by management and the compensation committee, a compensation peer group is targeted — typically consisting of 10 to 20 publicly traded companies of similar industry and size (generally with one-half to two times the company's revenue and a median revenue close to that of the company). Compensation data and information about compensation practices for nonemployee directors and executives are gathered from proxies and surveys and evaluated for market competitiveness against those of the peer group, typically aiming for within +/- 15 percent of the market target percentile.

It should be noted that recent IPOs with similar business characteristics (business model, brand strength, and/or operational complexity) may actually offer a more accurate peer comparison and should particularly be considered for companies lacking a sufficient number of similar-size industry peers.

In the public environment, the CEO, CFO, and general counsel are subject to heightened reporting and regulatory requirements, greater scrutiny, and increased shareholder expectations and communications. The company's board of directors should carefully consider whether the individuals in these roles pre-IPO are best suited to succeed post-IPO. In determining appropriate pay levels for these roles, the compensation committee should consider not only data from the peer group, but also the company's own performance, job structure, executive performance, and experience.

II. Equity compensation
Equity grants often represent one of the greatest recruitment and retention incentives for executives. The financial community and other investors see equity compensation as a key way to align an executive's interests with those of management and therefore look for executives with meaningful equity ownership.

However, determining how much is enough (or 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, the level of pre-IPO equity grants, concerns about valuation of the company pre-IPO, and accounting and tax issues regarding "cheap stock." Cheap stock refers to equity incentives generally granted during the 12 months prior to an IPO filing at valuations substantially lower than the IPO price and without objective evidence as to how the "fair market value" was determined. This potentially requires a restatement of historical financial statements and can result in increased stock-based compensation expenses.

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 with less opportunity for growth and companies with high-dividend payout ratios (real estate investment trusts, for example) tend to use restricted stock or 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; for CEOs at 2.3 percent and 2.2 percent, respectively, and 5 percent and 4.8 percent, respectively, for the top five named executive officers (NEOs).*

Underwriters usually prevent shares owned at the time of the IPO from being sold for 180 days post-IPO. This period, known as a "market standoff" or "lockup," allows the market enough time to fully absorb the newly issued shares, ensuring that market supply is not disproportionately increased, thereby driving down share price.

III. Pay and performance

Key factors that determine alignment of pay and performance are pay levels, pay mix, 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.

**Mercer IPO Research conducted in 2013 is based on SEC filings.*

Organizations 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.

IV. Agreements, plans, and policies

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 policy considerations are as follows.

Some companies want their incentive plans deemed "performance based" so that payouts do not count against the annual compensation tax deduction limit of $1 million for the CEO and the three other highest-paid officers (other than the CFO). Plans must meet a number of requirements in order to qualify as performance-based, but companies that disclose the material terms of their plans in their IPO registration statements get temporary relief from the requirements until the earlier of the first regularly scheduled shareholder meeting that occurs more than three years after the IPO or the date on which the plan expires or is materially modified. Less generous relief is available for subsidiaries of public companies that become public through spinoffs or other means.

- Often designed to garner proxy advisory firm support, equity compensation plans typically specify a reserve of available equity share awards of approximately 8 to 10 percent of shares outstanding.

- Stock ownership guidelines often require executives and nonemployee directors to refrain from selling all or a portion of their shares until they reach certain levels of ownership.

- Insider trading and anti-hedging policies prohibit transactions in company securities while company officers, directors, employees, and other individuals are in possession of material nonpublic information.

- Clawback policies require CEOs and CFOs to reimburse their companies for bonuses and other incentive-based compensation and for any profits realized on stock sales if companies must restate their financials due to material misconduct. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the U.S. Securities and Exchange Commission (SEC) and the stock exchanges must prohibit the listing of any company that does not have a policy to recoup compensation from all current executive officers after an accounting restatement caused by material noncompliance with any financial reporting requirement, regardless of misconduct. The SEC expects to propose rules for implementing this mandate in October 2014.

V. Regulatory compliance and governance

<u>Disclosure</u>
One of the most significant regulatory requirements is compliance with the SEC's executive compensation disclosure rules. These narrative and tabular disclosures address the compensation of the named executive officers — the CEO, the CFO, and the three most highly paid executive officers. A key component, the Compensation Discussion and Analysis (CD&A), must address

compensation objectives and specific compensation elements, including accompanying rationale, related support of objectives and the effect on decisions regarding other compensation elements.

"Say on pay"
Dodd-Frank requires that public companies hold a shareholder vote on executive compensation programs at least once every three years (known as "say on pay"). In 2013, 2 percent of S&P 500 companies failed to receive majority support; 7 percent received votes ranging from 50 to 70 percent. Although "say on pay" is an advisory (nonbinding) vote, shareholder votes (and the influence of advisory proxy firm advice on them) shouldn't be underestimated. A failed vote can have a number of undesirable consequences and is a signal to carefully review pay programs and evaluate ongoing relationships with policy and governance professionals at institutional advisers.

Working with compensation committees
Establishing processes and strengthening relationships among the compensation committee, internal resources, and external advisers can reduce the risks associated with executive compensation programs. Additional points to remember include:

- Stock exchanges must have listing standards relating to the independence of compensation committee members, the committee's authority to retain compensation advisers, and the committee's responsibility for the advisers' appointment, fees and work.* Compensation committees must consider six independence-related factors when selecting advisers, including compensation consultants and independent legal counsel, although committees need not reject advisers based on these standards.

- Stock exchange listing standards require a written charter covering the compensation committee's purpose and responsibilities.**

Final thoughts

Throughout the complex IPO process, executive compensation should remain a priority. Never before has there been more attention paid to the subject by investors, employees, and regulators alike. Having informed programs prepared well in advance can help mitigate risks while maximizing opportunity and value, so that when the market timing is right, companies can make their public exit in the strongest position possible.

###

(sidebar)

The Jumpstart Our Business Startups (JOBS) Act temporarily waives say-on-pay requirements and eases certain executive pay disclosures for "emerging growth companies" (EGCs). An ECG, defined as an issuer that first sold common equity securities after Dec. 8, 2011, and had annual gross revenues totaling less than $1 billion during its most recently completed fiscal year (indexed for inflation every five years), is not required to produce a CD&A, nor to hold a say-on-pay vote, and can take advantage of "scaled" tabular disclosures.

** Effective Oct. 2014 or by the first 2014 meeting, whichever comes first.*
*** Already effective for NYSE; effective for Nasdaq Oct. 2014 or by first 2014 meeting, whichever comes first.*