

# Best-Practice Guidance To Managing Executive Compensation Prior to an IPO

Once again, privately held companies are using initial public offerings (IPOs) to raise capital. Likewise, government enterprises outside of the United States are using them to join the private sector.

Although organizations' use of IPOs for these purposes is not new, the focus on governance issues while going through the process is. In fact, the IPO process provides a unique opportunity for these entities to prepare for the governance-inspired public scrutiny of executive compensation issues post IPO. The IPO process presents a "once in a lifetime"

opportunity to make dramatic changes to the executive plans, if needed.

It is easy to see why good governance is important to potential investors. When prudent investors choose to invest in one equity among the many available, they do so after weighing the risk of their investment. Companies with sound governance will have a lower-risk profile and can provide the returns the investor requires. In contrast, the share price of companies with questionable practices (in the area of executive compensation, among others) will reflect the market's distrust.

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## QUICK LOOK

- ➔ It is the compensation committee's responsibility to ensure that the company's executive compensation programs are ready for the public scrutiny that will occur post IPO.
- ➔ When prudent investors choose to invest in one equity among the many available, they do so after weighing the risk of their investment.
- ➔ Six key points are recommended to achieve "best practice" in compensation governance.



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## Readying Your Compensation Programs and Processes for an IPO

It is the compensation committee's responsibility to ensure that the company's executive compensation programs are ready for the public scrutiny that will occur post IPO. Compensation committees should consider the implications of their answers to the following questions:

- **Do the company's compensation and business strategies align?**

When an organization has not been in the public eye, it may be more accustomed to taking a more ad hoc approach to compensation decisions than following the dictates of a formal compensation philosophy. As soon as it believes an IPO is likely, the committee should take steps to define the organization's compensation philosophy and ensure that it aligns with the organization's business strategy.

- **Has the compensation committee developed a process of keeping itself and all board members informed about executive compensation issues and decisions?**

In preparation for an IPO and the public disclosure needed as a public

organization, the compensation committee's adviser should prepare for the compensation committee and the entire board summary sheets of total remuneration (tally sheets) paid to all executives.

- **Are the executive rewards structured in a manner that pays for performance?** Prior to going public, organizations must establish strong links between an executive's incentive pay (cash and equity) and the organization's performance and between organizational and industry performance metrics. Furthermore, these links must be communicated to shareholders in an understandable way.
- **Has the committee modeled incentive and equity-program payments under various performance scenarios?**
- **Do these equity programs lock in key executives post IPO?** Key executives often become vested in much of the equity they may accumulate during the IPO process. Because the total equity values eventually available to executives are often significant, the committee should make sure that at least some of this equity remains unvested for a period after the IPO so as to "encourage" post-IPO retention.

There are several approaches the compensation committees can take, though the choice of a specific approach will likely depend on how far away the organization is from the actual IPO.

- **Has the committee adopted equity ownership guidelines for executives, especially if the organization intends to introduce full-value equity share awards such as restricted stock?**

Adopting such guidelines helps justify to shareholders why executives will retain awards that are not performance based.

- **Are the organization's equity program documents flexible enough to accommodate the changing types of equity awards?** Do the current program

designs address shareholder groups' concerns around vesting and performance? Are there enough shares reserved to carry you for two years post IPO?

- **If employment agreements are in place to protect the executives' compensation in the event of termination without cause or in the event of a change of control, has the committee reviewed the amounts payable?** Shareholders are increasingly demanding that organizations reduce the level of severance under these arrangements. Finally, the committee should compare all incentive-plan documents for consistency, in terms of employment agreements and of intent in the event of a change of control.

## Six Factors of Sound Corporate Compensation Governance

Achieving "best practice" in compensation governance is fairly straightforward for organizations looking to privatize or those moving toward an IPO. Six key points are recommended:

- **Listing laws and regulations—** Companies moving to public offering must know and adhere to the standards of the jurisdictions where they will be listed.


- **Compensation standards**—Good governance is a core value that, when acted upon, communicates to investors that the board of directors and the executives are looking out for the interests of the shareholder. Good governance begins with a compensation committee whose members are independent, nonexecutive directors and that's maintained by a clearly defined charter. The compensation committee's charter is, in effect, a statement about the compensation issues it will address and policies it will follow regarding the executive pay program.
- **Sound business practices**—Executive compensation programs should be subject to a continuous development and refinement. Prior to the IPO, the compensation committee should implement procedures, policies and programs that will sustain sound leadership. Specifically the committee should:
  - Present to potential investors the compensation program. Any major changes to the program should be made before this communication. It is unwise to radically change or increase the pay program post IPO because of the negative message sent to investors about how the company will use their money.
  - Communicate confidence and stability to investors by using equity as a tool for rewards and for enhancing shareholder value.
- **State the organization's intentions**—Pre-listing regulatory filings are an opportunity to communicate an organization's plans for growth, continuity and executive leadership. When used properly, these filings can send the message to investors that their interests and the success of the company and its executives are linked.
- **Communicate success**—In accordance with applicable regulations and statutes, communicate the performance of the company. Most

organizations do this at least annually. Companies listed in the United States do this through the annual "proxy filing," while in the United Kingdom the annual report is most commonly used to communicate the performance of the business and its values, vision and mission. Reporting requirements have become more onerous over the years as regulators and investors demand increasing levels of clarity and transparency. Companies should consider going beyond the required minimum disclosure if the minimum disclosures do not adequately explain the company's activities to shareholders.

- **It's not just about executives**—Compensation planning during the pre-IPO stage involves more than just thinking about how to compensate and retain executives. It should also address how to possibly use equity compensation as a recruiting and retention tool for nonexecutive employees during the organization's expected growth post-IPO. Companies that fail to adequately plan for their broad-based equity programs often find that their insider holdings exceed acceptable levels and create a condition where outside investors' holdings are diluted if additional share authorization is needed. Organizations that plans three to five years ahead for their equity needs are less likely to have to explain in the future why they failed to properly manage their share program. As part of this planning, consider the following:
  - Equity is used as a recruitment tool, offered to new employees as an inducement to join the company. New employees will accept equity in lieu of cash compensation if they believe the value of the shares will exceed what they could earn through cash compensation.
  - Equity is the foundation of an Employee Share Purchase Plan (ESPP). These plans offer a limited

discount to encourage employees to buy company stock and share in the growth potential of the shares.

- Equity is used as company match for certain benefits programs, such as defined contributions programs (in the United States, a 401(k) program).

Planning equity requirements will address the needs of the business to support its HR programs not just through the initial public offering, but also for the several years that the company is going through its initial growth cycle. 

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#### EDITOR'S NOTE:

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- C6: Principles of Executive Rewards
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