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Viewpoint on Executive Compensation

Opinion Research Alert

Transitioning from a Pre-IPO to Post-IPO Company

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Introduction

Given that the IPO market has heated up in the last few years – 2013 brought us 222 IPO pricings in the U.S., up almost 80% from 2012[1] – we thought it worthwhile to look at pre-IPO equity practices and the implications for companies after the initial offering.

We start with some analytical findings for recent technology and general industry IPOs, followed by a list of ten key planning considerations as companies consider their post-IPO futures.

Our Samples

Our analysis is based on prospectus filings by companies at IPO. As such, these companies represent those pre-IPOs that were able to successfully conduct an initial equity offering. In addition, we limited our study to non-founder CEO companies because founder compensation often has unique aspects, which could have distorted the findings.

In total, we looked at 40 pre-IPO companies. Since the general industry companies that conducted IPOs during 2012-2013 tended to have a larger market capitalization at IPO, we selected technology IPOs from the 2007-2012 timeframe that had similar market valuations at offering.

Findings for Pre-IPO Companies

- *IPO companies in the sample granted a median of 10-15% of shares to employees during the pre-IPO period*
- *Stock options are the most common equity vehicle*
- *Technology companies deliver 50-80% more equity than general industry pre-IPOs*
- *Pre-IPO grants are typically made at hire or intermittently (not annually as we find at post-IPO companies)*
- *About 25% of equity is awarded to the top five proxy executives, with the CEO receiving half of that allocation*
- *At IPO, CEO gains from grants are $10-$15 million at the median but can vary significantly*
- *Performance conditions on pre-IPO grants are relatively common for general industry companies, but not technology IPOs*
- *Pre-IPO equity practices are very different than post-IPO practices, especially with respect to the type of equity used, and the grant frequency*

	Technology Companies	General Industry Companies
Total sample	22	18
Revenue size at IPO ($MM)	$234	$1,216
Market cap at IPO ($MM)	$1,029	$1,358
Time period of IPOs	2007-2012	2012-2013

(1) Source: Renaissance Capital IPO Center

The table below summarizes our findings for the Technology and General Industry IPOs with respect to: a) equity dilution/overhang, b) equity vehicle usage, and c) gains to executives at the IPO offering price

Key Findings Regarding Equity Practices		
Pre-IPO Element (median, unless otherwise specified)	**Tech IPOs**	**General Ind. IPOs**
Aggregate Dilution / Overhang		
Pre-IPO Dilution as % of Pre-IPO CSOs(1)	**12.5%**	**9.6%**
Range from P25-P75(2)	**9% - 18%**	**5% - 13%**
Reserve Requested at IPO as % of Post-IPO CSOs	**5.2%**	**7.5%**
Post-IPO Overhang as % of Post-IPO CSOs(3)	**19.3%**	**13.1%**
Range from P25-P75	**14% - 23%**	**11% - 22%**
Equity Vehicle Usage and Weight		
Prevalence of Options	**86%**	**82%**
Prevalence of Full Value Shares	**50%**	**41%**
Stock Option-Full Value Mix for NEOs	**79%-21%**	**77%-23%**
Gains on Pre-IPO Equity Grants at IPO		
CEO $ Gain at IPO Offering Price ($000s)(4)	**$14,824**	**$11,184**
CEO Range from P25-P75	**$6M - $25M**	**$5M - $21M**
CEO Gain Amount As % Market Cap	**1.4%**	**0.9%**
Other NEOs Combined $ Gain At IPO Offering Price ($000s)(4)	**$15,728**	**$11,799**
NEO Range from P25-P75	**$10M - $34M**	**$5M - $21M**
Other NEOs Combined Gain Amount As % Market Cap	**1.8%**	**1.0%**

(1) Dilution represents shares granted during the IPO period and excludes shares available for future grants; CSO = Common Shares Outstanding
(2) The P25 is the 25th Percentile or bottom quartile and the P75 is the 75th percentile or top quartile
(3) Post-IPO overhang includes both shares granted and shares available for future grant from both pre-IPO and post-IPO reserves
(4) Value is the gain on stock options and/or the value of restricted shares at the IPO offering price

Other Design Findings

- ***Performance vesting conditions:***
  - More common among the general industry sample with 50% of the general industry companies and 22% of the technology companies using performance vesting conditions on some portion of their pre-IPO equity awards
  - EBITDA was the most common performance metric

- ***"Celebration/Recognition" Grants to Recognize the IPO:***

  - Six of 23 technology firms (26%) made special celebratory IPO awards at or around the time of IPO at a median of 1% of outstanding
    - Two-thirds of those awards were broad-based grants
  - Ten of 18 general industry companies (56%) made special IPO awards with a median size of 0.4%
    - 70% were to the CEO/selected executives; 30% were broad-based
    - The greater prevalence of special executive IPO grants in this sector may be due to the lower pre-IPO equity stakes as compared to the tech sector
- **Evergreen Equity Plans**
  - An "evergreen" equity plan has a pool which replenishes each year by a certain percentage of shares outstanding
  - Almost all of the 40 pre-IPO companies referenced a new or recent equity plan established before the IPO:
    - Almost half of the technology companies had evergreen provisions in their Plans;
    - Only 18% of the general industry companies had evergreen provisions

General Comparison of Pre-IPO to Mature Post-IPO Equity Approach

Element	Pre-IPOs	Mature Post-IPOs
Grant Frequency	Predominantly at hire (up-front)	Annual grants and on a consistent cycle
Equity Type	Predominantly stock options	Portfolio of stock options, restricted stock and performance shares with variation depending on company size / industry
How Equity Grants Are Determined and Communicated	As a percentage of shares outstanding	As a fair value (or present value) at the time of grant
Performance Conditions on Equity Grants	A meaningful percentage of pre-IPOs use performance conditions for stock option vesting	Performance shares are the main vehicle used to include a performance condition on vesting (options and restricted stock typically have time-based vesting)

Planning for Post-IPO Compensation: Our Top 10 Considerations

There are many changes associated with the transition into a publicly traded company with many shareholders with diverse investment horizons, other stakeholders, and SEC reporting requirements to manage. Below is our Top 10 list of planning considerations in the area of compensation and governance.

1. Are the executive equity stakes large enough and "sticky" enough post-IPO?

Investors and Wall Street like to see meaningful equity stakes for senior management that show they, and especially the CEO, have "skin in the game" coming out of the IPO. This strengthens alignment between management and shareholder interests and also provides retention post-IPO. Therefore, it is important to

evaluate the size of the equity stakes and the vested and unvested portions as the company moves towards an IPO.

2. What should the go-forward equity granting strategy be?

Most pre-IPO companies make intermittent equity grants (either at hire or tied to special events like promotions). However, most public companies make annual grants—which provides for dollar cost averaging over time and a steady stream of unvested equity to enhance retention.

Most companies switch to an annual grant approach immediately post-IPO. However, there are certain circumstances which might argue for up-front awards instead. One situation is if the executives do not have significant equity stakes at IPO; in this case, the Board may decide that the first post-IPO grant should be front-loaded to cover the next few years.

Any new equity strategy should fit within a broader overall compensation philosophy, which also may be a new consideration. A compensation philosophy typically includes target market position, desired mix of pay and other guidelines to inform future Committee decisions and align them with ongoing strategy.

3. What types of vehicles should be used going forward?

As shown, pre-IPO companies continue to rely on stock options. Should a company transition to a more balanced portfolio post-IPO that includes restricted stock and performance shares? Considerations include:

- Is the company expecting high-growth post-IPO? If so, a stock options emphasis may still make sense
- Are there retention issues? If so, introduction of some portion in restricted stock may be useful
- Can the company reliably set performance goals? Eventually, public company shareholders like to see the use of performance shares, but an effective design requires the ability to select the right metrics that correspond to value-creation, and to set performance goals with a high degree of confidence.

4. Should an all-employee "founders" or "celebration" grant be made at IPO?

Decades ago, all-employee celebration grants at IPO were more common, used as a way to reward everyone for the IPO event. These types of grants are less common today because of the accounting cost and impact on dilution. Considerations include:

- How will a broad-based grant affect dilution and the share reserve?
- Did employees broadly participate in the pre-IPO equity? If so, an IPO grant may not be needed.
- Is there another vehicle for broad-based post-IPO equity participation such as an Employee Stock Purchase Plan?

5. Should a post-IPO peer group be established for external comparisons?

As a post-IPO company, establishing a post-IPO peer group of reasonably similar sector/size companies is often helpful to provide some external context on the talent market. Among other uses, it allows new post-IPO companies to understand competitive pay levels, practices, and dilution levels. Proxies also provide useful information on incentive designs and metrics used for incentive purposes. Generally, we recommend using peer group data as one, and not the only, factor in making pay decisions.

6. ***How should outside Board directors be compensated post-IPO?***

At most pre-IPO companies, Board members are investors who may not be receiving separate compensation for Board service. Once true outsiders are brought onto the Board, a reasonable compensation package is needed to attract and retain qualified candidates. This is another area where a peer group can be helpful to set up a competitive post-IPO Board pay package.

7. ***Are executive employment contracts necessary?***

If the CEO and senior executives do not have contracts pre-IPO, the Wall Street advisors often recommend contracts post-IPO to "lock executives in". On the other hand, shareholder groups and proxy advisors do not favor contracts. Because of proxy advisor and shareholder pressure, many post-IPO companies have reduced their use of executive contracts, especially for non-CEO positions, and moved towards using broader termination and severance policies instead.

If contracts are adopted at an IPO, it is important to avoid obvious shareholder irritants (like evergreen contract renewals, 280G excise tax gross-ups, and single trigger change-in-control severance and equity vesting), and to leave room for future flexibility. Further, incentive compensation should be expressed in terms of target opportunity subject to change / adjustment rather than promised future grants. Similarly, the use of supplemental executive benefits and/or perquisites should be reviewed closely, as such practices, while typically small in value, can be highly scrutinized.

8. ***What features should the post-IPO Equity Plan contain?***

Although IPO companies generally do not need to meet Section 162(m) requirements immediately, it is a good idea to include all the necessary features in the share plan so it is not necessary to re-file the Plan with shareholders in a few years solely for 162(m) reasons. Among the key things to do pre-IPO:

- Set aggregate and individual limits to meet Section 162(m) requirements in the future
- Include comprehensive list of performance metrics that might be used in the future
- Determine an appropriate and acceptable share pool, one which manages dilution but provides for multiple years of grants
  - Note that an evergreen equity pool does increase flexibility and reduce the chances of running out of shares, but the evergreen feature is an irritant to proxy advisors and certain shareholders and will likely need to be eliminated the next time the Plan is filed for shareholder approval
- Consider a fungible plan structure, which will allow for a shift from stock options to other vehicles in the future without re-drafting the equity plan for shareholder approval of full value share limits
- Carefully consider termination and change-in-control provisions against public company best practice

9. ***What kind of annual proxy disclosure will be needed?***

Relatively little attention has been given to the JOBS Act within the compensation world. Signed into law in April 2012, it allows qualifying companies to enjoy significant advantages with respect to disclosure requirements. As such, it is an area worth investigating to see if your company qualifies. In general, eligibility is for emerging growth companies with under $1 billion in total gross revenues (but is also affected by the size of convertible debt issuances and of a company's public float). While covered under the Act, a company can use abridged proxy disclosure and it not subject to a Say-On-Pay advisory vote.

Whether subject to the JOBS Act or not, it is a good idea for the new Board to articulate a compensation philosophy—i.e., the rationale for why executives are compensated the way they are. That rationale is the important ingredient to framing the pay-for-performance story in the first proxy.

10. What processes will be needed post-IPO?

As a starting point for the Compensation Committee:

- Set up the Charter, using published examples from public companies
- Establish a Compensation Committee calendar to make sure the correct items are reviewed at the appropriate times in the fiscal year
- Make sure the Committee members meet independence requirements

Making the transition from pre-IPO to post-IPO is a very exciting time for a company. While the executive compensation requirements may seem daunting, addressing these ten items will put organizations on the right path towards their post-IPO compensation futures.

General questions about this Viewpoint can be directed to Diane Lerner or Brian Lane by email at *diane.lerner@paygovernance.com* or *Brian.Lane@paygovernance.com*