Educating and Inspiring the World at Work
SEPTEMBER 2020
WORKSPAN

The IPO game

When to Play Offense or Defense in Exec Comp Design

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Organizations need to deliberately plan and communicate executive compensation objectives and structure in an initial public offering (IPO). Here, we will make real the choices at hand, describing when it makes sense to use compensation to play offense or defense. On offense, compensation can be used to communicate priorities and drive performance in the next stage of an organization's life cycle. On defense, compensation design operates more in the background to align pay with performance outcomes. We will compare the approaches and identify circumstances where each approach can work best to help newly public companies.

Offense or Defense?

IPOs can mean quite different things for different organizations, and these differences appear across companies often without regard to ownership structure or age of the business. On one hand, many companies view an IPO as a financing event only, with little impact on the day-to-day business. Employees may have joined the organization recently and have moderate value from equity awards, much of which is still unvested. The IPO is just another step in the organization's evolution, discussed mostly among the executives, and requiring only minor adjustments to compensation. Employees may experience varying degrees of wealth creation, but their liquidity may be limited by largely unvested equity grants. There is no immediate need for the pay programs to reinforce dramatic shifts in strategic thinking because financial- and shareholder-return objectives are already widely communicated to employees. In this case, a defensive program for compensation is appropriate to support "business as usual" for compensation.

For many other organizations, the IPO is a galvanizing turning point. The company may have been private long enough for their executives to have substantial vested equity and to have experienced significant value creation. The IPO gives executives an opportunity to receive liquidity on their equity. Fostering retention and creating excitement about the opportunity ahead is critical. In these cases, an offensive program with large upside opportunity may be appropriate to motivate key contributors while reinforcing the growth story to investors.

The goal in any IPO is to develop a durable pay program that supports the business' immediate objectives with the flexibility to adjust over time, if needed. Organizations always need to anticipate the "next act" from a pay perspective. Being intentional about the compensation approach at IPO has the added advantage of giving the newly public company a clear philosophy. The board should then plan to review this philosophy annually to ensure it still fits the company's financial, strategic, and cultural aspirations.

Stories of Offense, Defense and In-Between

On our advice, a longtime private company decided to go on the offense. Prior to IPO, the company had shifted to a new business line that super-charged its growth trajectory. The IPO would now fund

Figure 1: Contrasting Offensive and Defensive Approaches

	Offensive Approach	Defensive Approach
Annual incentive	Highly leveraged payouts, with maximum payout levels at 2x-3x target and steep leverage below target Financial goals that require significant stretch performance, often with heavy weighting toward growth Nonfinancial measures tied to specific strategic objectives, consistent with objectives outlined in investor road show	Moderately leveraged payouts, with maximum payout levels at 1.5-2x target and gradual leverage below target Financial metrics that are generally achievable with moderate performance levels, often with emphasis on profitability or returns
Long-term incentive	Large upside opportunity, delivered through premium-priced options or performance hurdles on equity awards Multiyear performance metrics Front-loaded equity awards	Market-competitive opportunity, delivered primarily through time-vested awards RSUs may be a larger component than options or performance shares Annual equity awards
Pay mix	Moderate salaries with greater emphasis on incentives, primarily long-term	Market-competitive and balanced pay mix of salary, annual incentive, and long-term incentive

growth so the company could capitalize on a significant market opportunity. The executives had substantial vested equity with a great deal of value. The board aimed to create excitement about the additional opportunity ahead and align compensation with the growth trajectory. Accordingly, it provided substantial upside opportunity in performance shares tied to achieving revenue and EBITDA (earnings before interest, taxes, depreciation and amortization) growth objectives. Additionally, the organization granted stock options to provide direct alignment to the stock price growth. This offensive approach reinforced the growth story to investors as part of the IPO.

Another client went defensive. The business viewed the IPO largely as a financing event and had no desire to drastically change compensation programs to motivate behavior or communicate priorities externally. As a controlled company, management was less focused on investor perspectives related to pay as the founder would continue to serve as CEO and own majority of the stock after going public. The organization reviewed the current pay program against public market pay practices and made only minor adjustment to employment agreements and board pay levels. It also transitioned the existing phantom stock plan to public company restricted stock units (RSUs) without providing large retention or staking grants at the time of the IPO. Management could thus continue with a business-as-usual approach through the IPO.

A third company we worked with used both approaches. It had two different groups of executives: One group had started the organization and built it to the IPO, but was not the team to take it to the next level; the second group, showing a great deal of promise, was getting ready to take over. The post-IPO compensation framework threaded this

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needle by giving moderate awards to the legacy leaders, who were wealthy through their substantial vested shares. On the other hand, the emerging leaders were set to receive far less value at IPO. The new compensation plan gave them a highly leveraged opportunity aimed at providing retention through several years of vesting. The design aligned with the long-term business strategy by encouraging the senior team to retire post-IPO. The design was effective because the board and key constituents discussed and agreed on the differentiated approach early in the IPO process.

Process Matters Too

Regardless of the compensation strategy, it's vital to align with the company's strategy, culture, management style and board perspectives. Alignment not only helps ensure investor acceptance, but also lays the groundwork for post-IPO success. The process should be firmly established and consistent because a clear process is often just as important as the approach ultimately adopted.

A robust pre-IPO process also sets priorities. Boards can focus on the "must-haves" of specific organizational needs while setting a timeline for addressing other items. It's not feasible to check every box before the transaction. To help set priorities:

1. Get early buy-in and involvement from key leaders
2. Approve a reasonable comparator group. Define how the group will and will not be used.
3. Have early discussions with directors — or investors if the board is still informal — to establish and articulate a compensation philosophy, including whether to go offensive or defensive
4. Create timelines for all needed approvals as well as beyond-the-basics decisions.

There is neither the time nor the need to work out the full governance structure before the IPO. But organizations can set a clear path to that state, with specific steps and timelines. The board needs to get on a regular cadence with committee calendars and agendas. This process should keep investor attention on the core issues of organizational performance and pay design, rather than on sideline governance issues such as executive ownership requirements. However, compensation governance issues not settled before the IPO, such as clawbacks, must be addressed soon thereafter.

Because uncertainty in the current environment continues, the IPO market is going to be more challenging than ever. An intentional approach to compensation strategy — with a well-designed compensation program tied directly to the company's objectives — can be critical to a successful outcome. **ws**

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IPO Basics

In preparation for the IPO, organizations need to complete the basics, no matter whether they take an offensive or defensive approach to compensation strategy.

1. **Share authorization.** How much equity should be reserved for future performance awards? The appropriate share pool combines a bottom-up forecast of requirements for equity awards, informed by the offensive or defensive approach, along with a top-down analysis of peer benchmarks for total dilution and annual run rate. The share pool should last for several years following the IPO to provide flexibility in delivering competitive equity grants. As part of this consideration, organizations should balance the size of the initial pool with any evergreen provision that provides automatic annual increases.
2. **Annual and long-term incentive programs.** Organizations often need to re-evaluate their incentive programs, even under a defensive approach. This could include moving to annual grant cycles for equity awards, or creating more sophisticated or standardized annual incentive programs.
3. **Employment agreements.** The IPO is an opportunity to move away from special arrangements, ensure that employment agreement terms are within the realm of competitive practice for public companies, and avoid egregious practices. Organizations should remove any provisions that would send unintended signals to the market or be embarrassing to disclose, such as overly generous severance programs or special perquisites. This is also an opportunity to adjust salary and target bonus levels for new executives and those taking on expanded roles.
4. **Board of director pay.** The organization must also set up a formal pay program for its independent directors. Most private companies pay directors primarily through equity awards with modest cash compensation. Establishing a competitive director pay program with balanced cash and equity awards provides certainty for new directors and recognizes the expanded fiduciary responsibility they take on at a public company.
5. **Employee stock purchase plan.** Less critical, but still important, is establishing a pool of shares for an employee stock purchase plan (ESPP). The implementation can come later once the appropriate administrative systems are set up, but the total share pool should be approved prior to the IPO. These plans are a low-cost way to create excitement in the organization following the IPO and help reinforce alignment with the stock price throughout the organization. Such plans can work in both offensive and defensive approaches.
6. **S-1 disclosure.** For each of these decisions, organizations should be thoughtful about the mandatory disclosure for equity plan terms and pay details. While disclosure requirements for emerging growth companies (EGC) are lower and a compensation discussion and analysis (CD&A) statement is not required, organizations may still want to divulge some details about the go-forward pay actions and strategy, particularly when taking the offensive approach.