Seeing Beyond the IPO

Tips Compensation Committees Can Use to Avoid Unintended Outcomes and Ensure Effective and Durable Compensation Programs

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Leading up to an IPO, compensation planning and strategy often take a backseat to the immediate business demands and actions that are required to take the company public. With so many new requirements, the focus of the Compensation Committee is often on the work needed to prepare for the IPO event, and not on the tomorrows that follow. These challenges are exacerbated for companies where the internal infrastructure is still being built. This short-sightedness can lead to reactive pay decisions, result in inequities (internally or versus the market), and expose a company to negative shareholder perceptions once the IPO halo has faded.

The compensation dynamics for a public company are wildly different from those of a private company. Going from one state to the other brings significant change and attendant challenges. There are different stakeholders, new regulatory and governance-related requirements, and a host of new and often unanticipated issues. In planning for an IPO, Compensation Committees would be well served to take a proactive, long-term view of compensation, and have a strategy and structure in place to guide the company through the transition.

We've developed five tips from our work with Compensation Committees before, during, and after an IPO. The extent to which these apply will vary by situation, but we've found they form a strong starting point for most Compensation Committees.

1 Don't feel compelled to check every box before the IPO. Prioritize the "must haves" from the "nice to haves". Pre-IPO, the long to-do list and myriad best practices can be intimidating. Not every pay practice needs to be reviewed and modified prior to the IPO. Certain items must be accomplished — like complying with governance and disclosure regulations and creating an equity plan. But others—like adopting stock ownership guidelines or refining the annual incentive design approach—can extend past the IPO if needed.

To think comprehensively and keep the big picture in sight: 1) create an inventory of compensation practices and programs that should be reviewed; 2) prioritize the list to ensure that, at a minimum, the "must haves" are completed pre-IPO; and 3) establish a formal timeline for addressing the other issues post-IPO to ensure they are considered and handled appropriately.

2 Recognize that a strong and consistent process is as important as the design decisions. The ad hoc decision-making processes that work for many private companies doesn't cut it in the public realm. Going public means different governance requirements, a broader group of shareholders, and enhanced disclosure rules that require defined internal procedures and processes to address. Without a strong, structured process, important items can slip through the cracks, jeopardizing your ability to make the right strategic decisions.

Strive to have a formal Compensation Committee process in place at the IPO that includes these elements:

a. Calendar for the annual compensation cycle. Include three to five pre-established annual meeting dates, high-level agendas for each meeting, and dates for approving key items.

b. Definition of roles and responsibilities. Cover key roles like the Committee Chair, other Committee members, CEO, key staff functions, and an independent compensation consultant (if applicable). Specify who should be in the room during meetings, who should review materials before they are final, and who is responsible for preparing and posting materials, etc.

c. Guidelines for Committee meeting preparation. Include deadlines for posting meeting materials (e.g., no later than five days before meeting) and the process for previewing materials with the Committee Chair and the independent consultant, etc.

3 Think about the "next act" and what it means from a pay perspective. Pay decisions today should contemplate the dynamics of tomorrow. The first few years as a public company are marked by significant change and uncertainty. Strive to develop pay programs that effectively address the current circumstances, but won't 'break' if the situation shifts.

For example, an "all options" approach works exceedingly well during times of high growth. But the moment growth slows or market valuations shift, years of option grants could be underwater. As a result, your company is now highly vulnerable to poaching from talent competitors. Anticipating and proactively addressing this potential shift by layering in time-vested restricted stock will provide some level of insulation and retention power.

Of course, it is impossible to know for certain what the future holds, but contemplating how changes in business and market dynamics might impact pay outcomes can help Committees develop balanced programs and minimize the risk of unintended outcomes.

4 Be aware of typical market practices, but do what is best for your unique business. Avoid the temptation to follow the pack. Pressures from shareholder advisory groups have led to an unfortunate homogenization of pay practices among mature public companies. Understand the common perceptions around public company "best practices", but be willing to be different if that is what is best for the business. This applies to all companies, but recently-public companies in particular should fight the pull to simply follow the traditional compensation design "rules."

For example, typical annual cash incentive plan designs set fairly tight performance ranges. This approach may not work well for newly-public, high-growth organizations where greater uncertainty and volatility heighten the risk of a broken plan. To offset some of the uncertainty, it may make sense to set wider performance ranges until the business becomes more predictable.

Be willing to do what is best for your specific organization, but be prepared to explain the rationale for being different to external stakeholders.

5 Don't let compensation related issues be a distraction. Compensation related decisions become more heavily scrutinized with each passing year after the IPO. It is important to anticipate the implications of the increasing external focus and ensure that problematic compensation practices don't draw the attention of shareholders and distract the Committee and employees from a focus on the core business.

Ensure external attention beyond the IPO is focused on company strategy and performance, as opposed to secondary issues of compensation and governance (e.g., top of market pay levels, the lack of executive ownership requirements, and outsized severance protections).

Additionally, be aware that decisions you make in the years following IPO will have a direct impact on how external stakeholders assess your pay programs in the future. Many newly public companies are provided a grace period where certain regulatory requirements, like Say-on-Pay, do not apply. Decisions made during this grace period will directly impact how shareholders and their advisory groups (e.g., ISS and Glass Lewis) assess your pay programs for the first Say-on-Pay vote. For example, ISS will look at the most recent three years of compensation levels to determine whether or not to recommend 'for' or 'against' your Say-on-Pay vote. Don't wait for these exemptions to lapse to begin planning for what they might mean for your company—it will be too late.

Final Thoughts

It is easy to fall into a reactive approach to compensation design, especially for newly public companies, where distractions are numerous and the business is evolving rapidly. Don't let that happen. Proactively establish a formal long-term compensation strategy and refresh it periodically. You will be more likely to foresee and avoid unintended outcomes, make compensation something that motivates rather than distracts, and create programs that serve the long-term interests of the business and shareholders.

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