

IPO Readiness: What Every Board and Compensation Committee Should Know and Do Before Going Public

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Executive Summary

- 2021 marked one of the most active years in the initial public offering (IPO) market in recent memory — both among traditional IPOs as well as special purpose acquisition companies (SPACs).
- Compensation program planning is a critical part of the comprehensive and time-consuming process necessary to transition from private to public ownership.
- There are several facets of the compensation program to consider through the transition, such as:
 - Establishing/Updating a Compensation Philosophy
 - Reviewing/Aligning Executive Pay Levels to Business Objectives and Competitive Practice
 - Developing a Long-term Incentive (LTI) / Equity Program Strategy
 - Reviewing/Establishing Severance and Change in Control Policies
- Advance planning, incremental decisions, and careful analysis of external and internal factors in each of the above areas can help.

Introduction

With the increase of special purpose acquisition company (SPAC) and traditional initial public offering (IPO) activity in 2021, it seems a private company not yet contemplating a public offering is a rarity these days. In fact, Renaissance Capital reports 397 US IPOs of greater than \$50M market cap in 2021 after 221 in 2020 and 162 in 2019.¹

The process of transitioning from a private to a public company takes significant effort across essentially all of a company's core functional areas over an extended period — often at least 6 months and, in many cases, closer to a year or longer. From a talent and compensation program perspective, the core tenet of rewarding executives and employees for driving business results (i.e., paying for performance) will remain; however, there are several key compensation program features and governance-related practices to consider when making the transition.

This Viewpoint discusses four compensation program areas of focus for management and the Board of Directors when an IPO becomes imminent:

1. Establishing/Updating a Compensation Philosophy
2. Reviewing/Aligning Executive Pay Levels to Business Objectives and Competitive Practice
3. Developing a Long-term Incentive (LTI) / Equity Program Strategy
4. Reviewing/Establishing Severance and Change in Control Policies

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We review each of these four areas below via a series of questions companies can ask of themselves as they begin planning an IPO.

Other critical elements to be reviewed and established prior to an IPO include a board of directors' compensation program, public company governance processes such as the Compensation Committee charter/calendar, Securities and Exchange Commission (SEC) disclosure requirements, and a new regime of preferred practices from external constituents including proxy advisors. We intend to cover each of these topics in subsequent Viewpoint articles.

1. Compensation Philosophy

We regularly encourage our clients to adopt and codify a compensation philosophy. A well-documented compensation philosophy includes the primary objectives of pay programs including the purpose of each component, a statement on desired competitive positioning and external market comparators, and a set of guiding principles reflecting company values and actions.

Key Questions To Address	Pay Governance Perspective
Compensation Philosophy	
• Objectives: What are our guiding principles and objectives? • Elements: What pay elements will we use to drive business and talent strategies? What is the appropriate pay mix? • Frame of Reference: How do we define our competitive market for talent? • Competitive Position: What is our targeted level of competitiveness? Should our competitive positioning vary by pay element?	• We encourage our clients to establish philosophies that set parameters around pay decisions while allowing flexibility to use various quantitative and qualitative factors in each decision — e.g., median overall pay positioning with the ability to pay above or below for high-caliber and/or unique talent, including within new hire/promotion scenarios.
Public Company Market Comparator Group (“Peer Group”)	
• Selection Criteria: Which are the key characteristics of our company that should be reflected within our peer group (e.g., industry, revenue, market cap, headcount, profitability, geographical footprint, etc.)? • Peer Group Use(s): Should we have more than one peer group (e.g., one for understanding competitive pay levels and one for incentive and related governance practices)? • Sample Size: How many peer companies are appropriate to provide robust competitive information? • Established Public vs. Recent IPOs: Should our peer group include recent IPOs, established public companies, or a mix thereof?	• Developing an informative peer group goes beyond industry and size parameters. Factors such as margin, business/customer type, expected valuation (absolute or relative to sales/earnings), and growth trajectory all can have implications for pay practices. • We tend to err on the higher side in terms of number of peers (i.e., 20-25 peer companies) in IPO-readiness engagements, as it provides coverage for limited disclosure, unique practices among peers, and/or potential churn in the group over time. • Including recent IPOs as peers can provide insight into practices relevant to a company's near-term IPO-related decisions; however, in our experience, these designs and practices may differ from those employed by established public peers. One point of caution is that recent IPOs may have less robust disclosure.

2. Executive Pay Considerations

With respect to total compensation, the change in ownership structure can have a direct impact on the level of pay required to maintain competitiveness for some positions. While not always necessary, an IPO provides a chance to revisit pay levels to better align with short- and long-term business and talent priorities as well as to ensure appropriate compensation for any expansion of position responsibilities. For example, responsibilities for certain positions within the Finance and Legal functions, to name a few, can increase upon the IPO due to additional reporting requirements and may warrant higher compensation levels.

Key Questions To Address	Pay Governance Perspective
Cash Pay	
• Competitiveness: Are our current cash pay levels (e.g., salary and/or annual incentive opportunity) representative of competitive public company levels and do they reflect our go-forward compensation philosophy? • Adjustments: If below market, when is the right time to implement pay adjustments? At IPO or at the first annual merit cycle as a public company? All at once or over time?	• With respect to the competitiveness, many private companies adhere to a lower cash and higher equity philosophy (often due to a conservative approach to cash burn and other factors) — acknowledging this difference is important in reviewing the competitiveness of cash pay against public comparators. • A company's compensation administration cycle should be considered when adjusting pay. For example, if the annual merit cycle is soon after the (e.g., 1-3 months) IPO, then waiting on pay adjustments provides an opportunity to assess the success of the IPO and executive performance relative to expectations.
Equity Awards	
• New Paradigm: Public companies predominantly use an annual grant cycle for making equity grants - Are we prepared to shift our thinking to an annual grant approach based on grant date dollar value? • Competitiveness: How do we define competitive equity awards as a public company?	• The inherent difference in approach to granting equity makes direct comparison between private company equity awards and public company challenging. It is important for pre-IPO readiness equity award reviews to focus on establishing a new annual structure vs. direct comparison between private and public award levels — among pre-IPO companies, percentage of ownership is a common approach to understanding market competitiveness vs. annual dollar value at grant or upon vest among post-IPO/public companies.

3. LTI / Equity Program Strategy

The primary executive pay change for companies transitioning from private to public status is the shift in approach to equity awards. While there are several differences between private and public equity practices (see Figure to the right), a key difference is award timing:

- The prevailing equity strategy for private companies is event-based awards (i.e., larger/multi-year awards made at hire, promotion, major company milestone / dilutive event) with a focus on targeted aggregate ownership.
- For public companies, the prevailing strategy is annual equity grants with a focus on delivering a targeted grant date dollar value or, in some industries, a vesting dollar value.

Award Element	Private Company	Public Company
Grant Frequency	Event based (e.g., hire, promotion)	Annual
Basis of Granted Opportunity	% of company or potential value	Grant date fair value or potential value upon award vesting
Vehicle	Appreciation based (e.g., stock options, stock appreciation rights)	Portfolio, including time-based and performance-based awards, for executive roles Generally time-based awards below executive level
Vesting	4 to 6 years	3 to 4 years
Shareholder-related Factors	Single or small group of investors	Proxy advisors, institutional shareholders, SEC disclosures
Liquidity	At transaction	Ongoing, within trading windows

It follows then that the most important compensation considerations in going public is determining the go-forward LTI strategy. LTI awards represent a key component in attracting/retaining talent and are usually a significant component of overall compensation. During the IPO-readiness phase, LTI plan design and allocation of shares for future grants is highly important and cannot be overlooked. Plan designs and mechanics can take many forms depending on industry- and company-specific factors. The governing plan documents tend to remain broad and allow for flexibility to change designs and award types over time without needing to amend the LTI plan.

Key Questions To Address	Pay Governance Perspective
IPO Awards (e.g., Founder/Retention Awards)	
• Purpose: Should we reward a select group of employees for their IPO-related contributions or more broadly recognize all employees? • Eligibility: What criteria will be used to determine recipient award size (e.g., affordability, employee level, retention risks, share usage/dilution levels, etc.)? • Award Design: Should the IPO award vehicle and design differ materially from the annual LTI award approach?	• Equity awards at IPO (also known as founder awards) can be a great vehicle for recognizing the accomplishments leading up to IPO — they not only provide employees with more of an opportunity to become owners: they can also be celebratory while directly aligning recipients with a new broader shareholder base. • Further, if retention is a concern for key employees (e.g., if historical pre-IPO equity awards are near full vesting), IPO awards can refresh retention over a multi-year period. • The decision to grant founder awards is unique to each company's situation, industry, dilution levels, etc.

Key Questions To Address	Pay Governance Perspective
Post-IPO LTI / Equity Strategy	
• Objectives: What are the objectives of the LTI program? • Market Practice: What types of awards do our competitors use? • Eligibility: What criteria will be used to determine eligibility? • Award Design: What vehicle(s), vesting conditions, and award terms best align with our business and talent strategies? Should our approach differ by employee level?	• LTI objectives generally fall in two broad areas – performance-oriented grants designed to appropriately reward future financial and/or shareholder performance or retention grants designed to keep participants in place at the company • We encourage our clients to think primarily about their internal strategic objectives and talent strategies in designing their LTI program and secondarily about market competitive practices.
LTI Plan Document	
• Timing: When should the company seek board approval on the go-forward plan document? • Share Pool and Usage: How many shares should be available for grant? What are appropriate levels of dilution at IPO and post IPO? Should the plan include an evergreen provision? • Plan Provisions: For many of the provisions common within an equity plan document, the key questions are of balance... — ...between flexibility to account for growth and expectations from shareholder groups on shares reserved. — ...between what should be included in the governing document and what can be handled via grant agreements. — ...between appropriate protections for the company (e.g., restrictive covenants) vs. the award recipients (e.g., termination coverage). • Key provisions to pay specific attention to include: — Evergreen refresh — Share recycling methodology — Board of director grant limits — Termination provisions (treatment of unvested awards upon termination without cause, voluntary termination, death, disability, and other forms of termination) — Change in control protection — Shareholder approval for option repricing	• It is virtually universal for a company to establish, and for its private shareholders to approve, a new equity incentive plan document prior to IPO. • Appropriate plan provisions can be implemented to protect both the company and employees while allowing sufficient flexibility for desired employee participation based on current and projected headcount. • We note certain provisions common among newly public companies (e.g., automatic annual refresh features typically referred to as “evergreens”) are generally viewed unfavorably in a public company setting — primarily by outside shareholder advisors.

In addition to adopting an LTI plan to promote employee ownership and align with market competitive award designs, a company may want to consider adopting an Employee Stock Purchase Plan (ESPP), which is the right to allow employees to purchase stock at a discount.

Key Questions To Address	Pay Governance Perspective
ESPP	
• Plan Type: Will the company adopt a qualified IRC Section 423 plan or non-qualified 423 plan? • Share Pool: How many shares will be reserved under the ESPP? Will the plan have an evergreen provision? • Key Plan Provisions: Minimum service requirement, stock price purchase discount (e.g., 15% of fair market value), length of offering periods, forms of compensation that can be used to purchase stock, and individual contribution/purchase limits.	• An ESPP is a great vehicle to facilitate broader employee ownership. • The most common type of plan is a 423 plan which provides employees a preferential tax treatment on the discounted company stock purchased (i.e., a qualified 423 plan). • While an ESPP can be a wealth accumulation opportunity for employees, companies need to spend a significant amount of time investing in an ongoing communication strategy to help employees understand the benefits and work to ensure employees retain the shares after receiving them through the plan.

4. Reviewing Severance Coverage / Termination Policies

Severance benefits and termination treatment is another area typically discussed before going public. In addition to creating policies to align to market competitive practices, such policies can also be used to attract and retain key executive talent.

Key Questions To Address	Pay Governance Perspective
Severance / Change-in-Control Benefits	
• Documenting Benefits: Should severance provisions be included in employee agreements or as a stand-alone severance policy? • Termination Events Triggering Benefits: What benefits will employees receive upon termination for cause, death, disability, or without cause? Should the company's termination benefits vary by employee level? • Defining Non-Change in Control (CIC) Benefits: — Should a cash benefit be defined as salary only or salary plus annual incentive? — If annual incentive is included, how will it be defined? — What multiple will be used to calculate the cash severance and how will the multiple vary among different levels of executives? — What will happen to unvested equity? If stock options are granted, what will the	• Adopting a severance plan or including severance provisions in employment agreements can serve as a beneficial tool to attract and retain key talent. • It is a good practice to apply consistent terms and conditions across participants (i.e., severance benefits should be harmonized, and companies should avoid disparate termination benefits by individual). • Among publicly traded companies, we have observed a broad trend toward severance plans rather than individual employment agreements. • The LTI plan document and/or related award agreements can also be used to specify the treatment on unvested equity awards for various termination events if employment agreements or a severance plan are not definitive on the issue.

exercise period be for vested awards upon the termination event?

- Will health and welfare benefits continue to be provided?

• Defining CIC Benefits:

- Similar questions to above with the added discussion of whether benefits should be enhanced in any way if qualifying termination occurs post CIC

Conclusion

The IPO journey can range from 6 months to as long as 2 years or even longer and it is never too early to start planning. The timeline below summarizes the key considerations and timing for companies that are considering an IPO.

Pre IPO: 6 months to 1 year	Pre IPO: 6 months to public offering	At or Post IPO
• Understand competitive landscape post-IPO • Finalize competitive market peer group • Develop high-level compensation philosophy framework • Draft LTI Plan / ESPP • Understand public company disclosure environment / shareholder scrutiny / proxy advisors' guidelines	• Benchmark pay levels (cash and equity) • Develop Board of Director compensation program • Develop incentive strategy (both annual and long-term incentives), including type and design of vehicles and grant guidelines • Perform an equity share pool analysis • Draft Employment Agreement template • Populate plan documents with final share reserve figures (equity plan and/or ESPP)	• Adjust total direct compensation levels as necessary • Adopt and finalize annual and LTI plans; participant communications • Update compensation administration policies (compensation administration calendar, equity vendor, etc.) • Governance: Finalize compensation committee calendar/agenda items

Compensation programs are one part of the overall IPO process. Early planning, reliable and experienced partners, and a commitment to making decisions in an efficient, effective and timely manner (e.g., establish objectives, review relevant information, discuss directional considerations, make preliminary decisions, and adopt final changes when full information is available) can help the process run smoothly. Thoughtful and early planning can take the stress out of what is likely an exciting time for employees, management, investors, and Directors and support the all-important transition to public company status.

General questions about this Viewpoint can be directed to Brian Lane at (brian.lane@paygovernance.com), Joe Mallin (joe.mallin@paygovernance.com), or Tara Tays (tara.tays@paygovernance.com).

¹ "U.S. IPO Market." Renaissance Capital. January 7, 2022. <https://www.renaissancecapital.com/IPO-Center/Stats>.