GOING PUBLIC

The Factors and Forces that Shape an IPO

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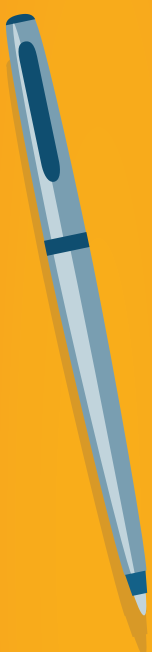
We are entering the holiday season, a time for hope and optimism. This changing of seasons is like the transition many companies encounter when converting from a privately held organization into a full-fledged publicly traded company through an initial public offering (IPO). Although the typical IPO process takes months from announcement to trading, the preparation leading up to the IPO starts well in advance, not unlike preparation for all the holidays' special events. There is a tremendous amount of hard work, dedication and preparation that is needed to assure the company's IPO kickoff is well positioned for success.

Balancing Multiple Interests

Before entering the complex art of plan development, it's important to understand the many interests tied up in an IPO, leading up to and continuing beyond completion. There are executives/employees; board members; private equity; lawyers (and lots of them); shareholders; various consultants; investor advisory firms; and the U.S. Securities and Exchange Commission (SEC). While these various



interests usually are aligned toward the primary goal of completing the IPO, there are many issues on which they diverge, mainly the costliest expense — executive compensation.

Executives bear the most significant burden within the IPO process because they must balance the process of ensuring decisions are made in the best interests of shareholders, working on every aspect of the process, all the while positioning for a competitive compensation package. This often puts them at odds with their private equity sponsors and other shareholders who view compensation as an expense, rather than an investment.

Independent board members in an IPO scenario typically are being brought in to help ensure proper governance in a public environment. They are interested in overseeing the well-being of shareholder interests while also retaining and motivating executives to perform through and post IPO.

Private equity interests typically have one goal in mind: Maximize returns. This is their business model, and they shouldn't be blamed for attempting to maximize their investment. However, this typically means compensating executives is viewed as a necessary expense, not an investment. Further, post-IPO compensation often is viewed through the lens of how much executives made through the IPO transaction, not necessarily what is competitive in the market. The private equity contingent often is the most difficult to persuade and negotiate with, and often requires significant supporting documentation and market education on compensation arrangements.

In connection with going private, companies will be required to file information with the SEC regarding many issues, including compensation, which is filed through many different forms (e.g., 10-K, Compensation Discussion & Analysis (CD&A) section of the proxy statement, 8-K, Form 4). With the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Section 951 allows for investors/shareholders to hold a nonbinding vote on the company's executive compensation program. This action, known as say on pay, has widened the lens of exposure that public companies encounter and led to the emergence of shareholder advisory firms such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co. LLC.

Those investor advisory businesses play a significant role in structuring compensation plans for public companies' executives and independent directors. These firms are designed to protect shareholders and inform them of key governance items that could affect voting outcomes. Although conceptually this idea is good and noble, their models rarely generate consistency and more often result in outcomes that are largely contested. Compensation committees must remain aware of their impact.

Aligning Strategy and Compensation

Privately held organizations realize greater flexibility in the development and management of executive compensation. But as a private company transitions into being public, greater challenges and oversight from a variety of sources must be managed. The most important question to answer in setting up a pre-IPO compensation program is: "Where are we versus where do we need to be in structure and value delivery compared to the marketplace?" The ensuing assessment should allow for the setting of a level playing field with the new competitive marketplace and act as an opportunity to correct potential shortfalls or areas that may have previously been below market standards.

An important part of the assessment is to determine what the competitive market is to set the foundation of the compensation program. Based on our Generally Accepted Compensation Principles, the market should be defined using a blend of established compensation surveys and a grouping of peer companies that are publicly traded. This peer group, which will need to be disclosed in the CD&A section of the proxy, should represent an amalgamation of various factors that reflect similar companies. Similarity should include a mixture of financial measures (e.g., revenue, market capitalization, assets, enterprise value) and operational measures (e.g., industry, the geography of headquarters or operational areas, competition for talent).

Once the competitive market has been defined, comparing and contrasting the current compensation programs with the external market will allow for decisions and recommendations to be made to programs that fit with the overall goals and culture of the company. The following factors should be assessed for cultural fit and market alignment:

Base salaries. Once entering the public marketplace, the responsibilities of key executives oftentimes drastically change. For example, the CEO and CFO will face new responsibilities such as shareholder and media outreach and certification of all financial statements under the passage of the Sarbanes-Oxley Act in 2002. A compensation philosophy best guides the determination of proper salary levels relative to responsibility and specific individual factors, such as experience, tenure and performance.

Targeted annual incentives (bonuses). In many private companies, annual incentive opportunities are based on the discretion of ownership and/or the management team with little or no disclosure on how awards are determined. While this flexibility can have both positive and negative effects, the discretionary decisions can be confusing. As a public company, much of this discretionary confusion is cleared up due to disclosure rules requiring an explanation and, to varying degrees, the factors and measurements that are used to determine awards. This disclosure includes target award levels, performance measures, the weighting of measures and the results that correlate to actual awards. However, there oftentimes remains a small portion of the measurement that is based on discretion in a newly public company due to the unpredictability in forecasting goal targets and estimates in the first few post-IPO years. Therefore, it is advisable to annually review and re-evaluate the incentive plan to ensure it is driving company results and desired individual behaviors while being tied to the success of the business.

Long-term incentives (equity and equity equivalents). Long-term incentives (LTIs) are the biggest compensation difference between a private and public company. Executives and employees in private companies oftentimes do not receive equity grants like their public counterparts. Instead, they typically are awarded a cash-based LTI that is tied to specific goals (i.e., retention or achievement of performance goals). This approach often is taken because of a lack of liquidity (i.e., the company is not publicly traded, and/or the founders want to maintain whole ownership of the business). On the other hand, for private companies backed by a venture capitalist, the strongest draw is equity, often in significant multiples compared to public companies. This is intentional, to draw the talent needed to grow the value of the company. The trade-off for prospective employees is a

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greater risk of not realizing their large equity grants versus the reward in a public company with in-the-money equity grants that are lower, but not as risky.

In both public and private companies, LTIs are seen as the greatest link to long-term retention and motivation. In recent years, public companies have started to rely on LTIs as the driving force of their compensation programs, with awards consisting of 40% to 75% of the total package. These LTIs come in many forms, such as restricted stock, performance shares, stock appreciation rights and options. Each of these has its own merits. Deciding which vehicles will deliver the best motivation may vary by company due to strategy, share usage concerns, overhang and shareholder sensitivities.

Change-in-control provisions. Publicly traded companies face a greater possibility of mergers and acquisitions (M&As). These M&As are not always in the best interests of individual executives, but they generally benefit shareholders. With the possibilities of M&As, it is imperative to keep executive leadership focused on the best interests of the company and shareholders by providing protection in the event of change in control. This protection is intended to provide some assurance to plan participants in the event the company is met with a potentially

accretive transaction that may result in the loss of their role within the company. These change-in-control plans have begun to be more shareholder-friendly, whereby multiple criteria must be met for a payment to be made. These criteria often are referred to as a double-trigger event. The most common double trigger is when the company is sold and the executive is terminated within a predetermined time after the closing of the transaction. Change-in-control provisions typically are reserved for only senior officers. Amounts and constructs will vary from the CEO to the other senior officers. However, the prevalence of widespread change-in-control programs is growing as a means of protecting the larger employee population.

Independent director compensation. The compensation of the independent directors of the board has come under scrutiny. As good governance, independent director compensation should be viewed under the light of paying for governance and oversight versus pay for performance. Market best practices have shown that directors should be compensated primarily through annual cash retainers and company equity. The annual cash retainer typically is paid quarterly and may include additional compensation for being the chairman or members of a board subcommittee while the stock-based compensation element makes up from 50% to 75% of the total annual fee that is time vested.

It is always important to monitor and evaluate external forces that can affect compensation programs. These forces include investors/shareholders; internal equity; legislation; employees; and the board of directors. Each of these groups will have various interests that may not always be aligned with the best interests of the company and its compensation programs. However, thinking in the company's best interests and maintaining sound governance and ethics will help you reach IPO success. Going public for a privately held company takes a tremendous amount of hard work and dedication, with the ultimate key to success being preparation and knowing all the various stakeholders involved throughout the process. **WS**

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