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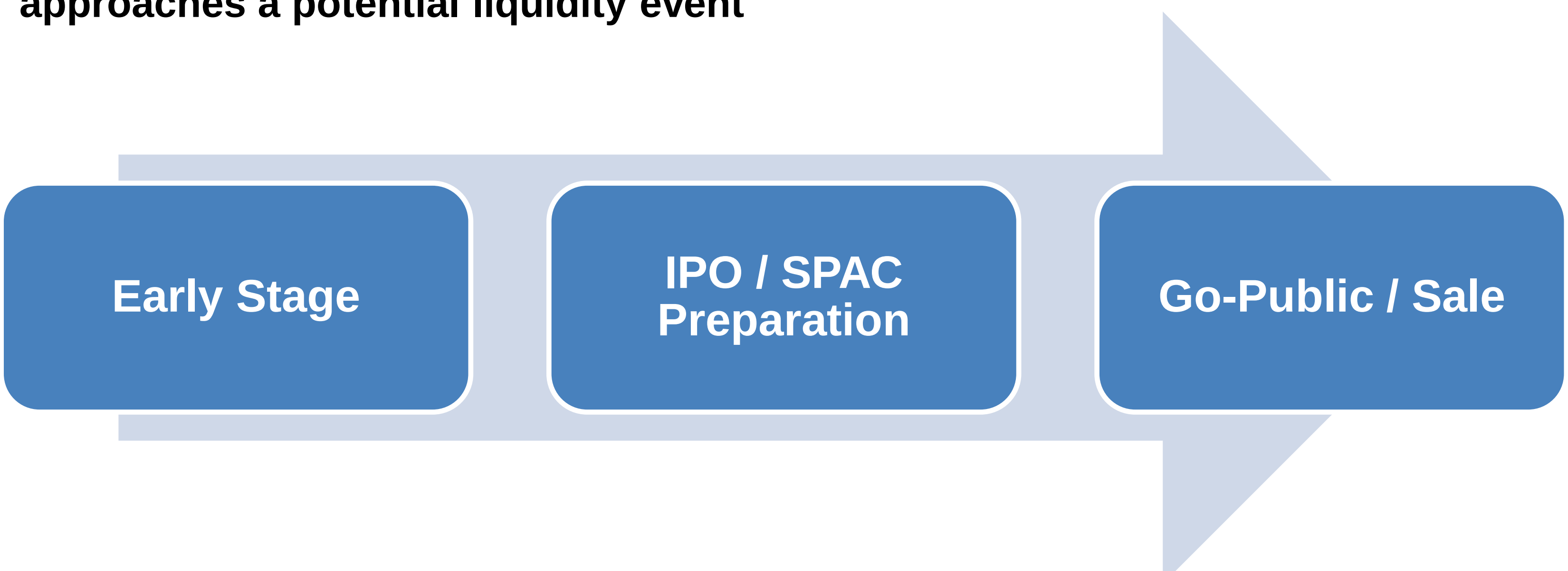
Executive Compensation Practices in PE-Backed Companies

PE-Backed Company Life Cycle – Executive Compensation Issues

The fundamental principles of executive compensation apply across nearly all company types

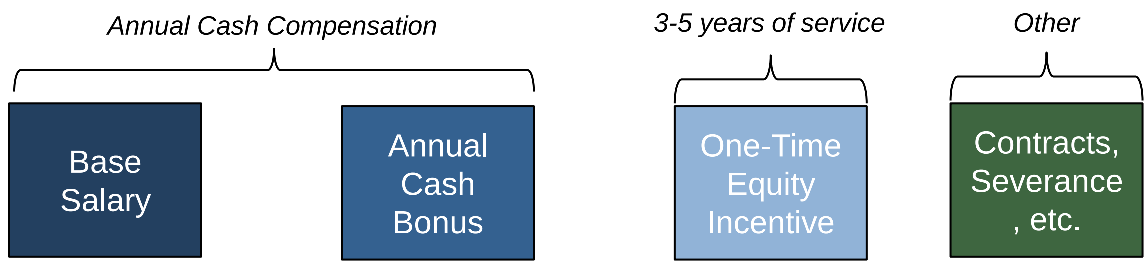
- Attraction/Retention
- Alignment
- Governance

While key areas of focus will change as a PE-backed company matures and approaches a potential liquidity event



PE-Backed Compensation Mix

- PE-backed executives generally receive salary, cash bonus and equity incentives as components of compensation with the equity-based incentive representing the largest and most important element of pay



- **Cash compensation** (salary + bonus) is often <u>targeted between the 25th and 50th percentiles</u> of market, relative to similarly sized public companies
  — In early stage companies, cash bonus may be based on achievement of strategic milestones or revenue growth. As the company matures, performance metrics typically focus on EBITDA growth
- **Equity incentives** often provide an <u>opportunity to earn 75th percentile+</u> relative to public companies, with the potential realized equity value over 5 years often double what might be typical within a public company – ***assuming performance objectives are achieved***
  — Equity incentive design is generally in the form of <u>**Profits Interest Units**</u> or <u>**Stock Options**</u> for PE-backed companies

Equity-Based Incentives

- Equity incentive is typically front-loaded with the expectation to cover 3 to 5 years of service
  - If liquidity expectations get pushed beyond 5 years, some firms may provide a “refresh” grant. However, typically no additional awards are made prior to an IPO/sale
- Size of equity incentives awarded to executive vary depending upon:
  - Initial market value of the company – *larger market value requires smaller % of common stock to deliver equivalent opportunity*
  - Risk profile of the company – *higher risk typically correlates to larger % offered*
  - Industry sector – *competitive pressures within some industries may command larger % grants*
- In our experience, a common initial equity award to a non-founding CEO often ranges between 4%-6% of common equity
  - This often translates to the opportunity to earn $15M-$30M under “base case” performance projections, often with the potential for much more
  - A founding CEO will typically hold significantly more equity, however this is less related to compensation and more a factor of capital financing choices
  - Many CEOs are also offered co-investment opportunities, but these also are less compensation-related and more investment related

Equity-Based Incentives

	Profits Interest Units	Stock Options	Restricted Share Units
Description	Incentive units are issued to executives in an LLC. The LLC is funded with company shares as ROI objectives are achieved.	Provides the option to purchase shares in the future at stock price upon grant. Rewards for growth in share price.	Direct share units that will be settled in shares in the future. Typically with time-vesting restrictions only; however, other performance conditions could be attached.
Design Complexity	*Moderate to High* – Requires separate LLC and ROI determinations	*Low to Moderate* – Requires equity valuation upon grant	Low
Performance Alignment	Closely aligned value creation with direct connection to ROI	Leveraged connection to appreciation in value	Aligned to shareholder value with less downside risk
Value Potential to Executive	*High* – Significant upside opportunity if return targets are met.	*Moderate to High* – Leveraged upside opportunity depending on option valuation	*Low to Moderate* – Upside limited by share price growth
Taxation	Typically taxed as ***capital gains*** upon distribution, if structured appropriately	Taxed as ***ordinary income*** upon the exercise of option by executive	Taxed as ***ordinary income*** upon share settlement

Preparing for Going Public (IPO/SPAC)

Going public requires a number of changes in compensation programs and governance. Shareholders expect a strong link between pay and performance, and it is an ideal time to evaluate if the compensation strategy, programs, policies and processes best position the company for continued growth and development.

The chart below provides an overview of the common areas of emphasis to prepare a company's executive compensation program for the transition to a public company:

Compensation Philosophy
- Articulate pay philosophy based on business objectives and strategy

Competitive Benchmarking
- Develop peer group to reflect public company status
- Benchmark compensation levels
- Benchmark compensation design
- Benchmark IPO pay practices

Outside Director Compensation
- Benchmark compensation provided to directors relative to peer companies
- Develop competitive pay package to attract and retain independent outside directors

Public Company Incentive Design
- Develop annual incentive plan to focus on post-transaction objectives
- Design public company long-term incentives
- Model equity utilization and share pool needs

Transition of Existing Plans
- Assess impact of the transaction on existing compensation arrangements
- Identify retention needs

Transaction/IPO Specific Equity Grants
- Consider the need for one-time special equity grants
- Design special award vehicles and grant sizes
- Model share dilution impact

Compensation Committee Governance
- Committee charter
- Committee calendar and process
- Key policies:
  - Clawbacks
  - Anti-hedging, anti-pledging
  - CIC and severance arrangements
- Public disclosures (i.e., S-1, proxy statement)

Transitioning to Public Company Equity Grant Practices

- Nearly all public companies award equity incentives on an annual basis
- Many IPO companies will award a larger grant of equity incentives at the time of IPO