Going public? Plan your equity strategy closely

Research shows that compensation committees can follow some general rules to get a head start.

BY STEPHEN CHARLEBOIS, OLIVIA TAY AND LAURA WYATT

Is your company's IPO on the horizon? Among many things you'll have to think about, one is pay program design and equity usage as you go public. If you're wondering what best practice is, the results from recent research give some general guidelines to follow.

Semler Brossy Consulting Group researched middle market IPOs, generally in the $1- to $5-billion in annual sales range, over the last five years. Results show that compensation committees and management should consider six general rules for equity usage and program design:

1. Keep the equity overhang at IPO below the high teens. We find that if a company has overall dilution in the high teens going into an IPO, it restricts its flexibility and ability to adapt to changing circumstances. At IPO, the research suggests an overhang of 17% or below is a safe starting point.

2. Aim for an annual run-rate of about 1% by year three. Companies should have a run-rate (total shares granted compared to total shares outstanding) of at least 0.5% to be competitive. Research suggests that the variance in run-rates narrows over time and normalizes to about 1% per year (see exhibit).

3. Grant about 20% of the available equity pool each year. Companies that retain 80% of the pool will have enough equity for eligible employees for four to five years. Non-founding CEOs should often get about 15-20% of the annual pool. Think of this as an 80/20 rule to start, and tweak specific grant levels from here; adjust for fungible ratio as needed.

4. Expect to replenish the pool within three years of IPO. Using the 80/20 rule, you'll need to go back for more shares in three to five years. At least one third of companies go back for more shares within four years. Compensation committees should anticipate the complexity of getting shareholders to approve share dilution at this time. Proxy advisor scrutiny and shareholder value transfer requirements become more stringent and governance-oriented after the third year.

5. Add performance shares within the first four years. Plan to introduce performance shares, which may require amending the equity plan. This will align the company with market trends. Be sure to start discussions early to consider how pay will support the strategic objectives of the organization. Programs with a high degree of performance orientation take time and effort to develop.

6. Be ready with contingency plans should you encounter surprises. Be sure to have a written plan that outlines what happens if your share price plunges. How will you reward executives? Semler Brossy suggests a longer-term outlook for granting shares at low stock prices. Do you grant a specific number of shares? Do you keep grant-date fair value the same? What's the optimal "meet-in-the-middle" solution for your company and its executives?

There are always exceptions to the rules. In coming up with those above, however, we excluded financial services and technology companies, special-situation IPOs such as limited partnerships in the energy industry, and IPOs where founders remained CEOs. We wanted to avoid the outliers. We also looked only as far back as 2010. But the lesson from the research is plain: the pay program requires diligent planning, starting well before the date of going public.

This is especially true as the structure of equity-financing options continues to evolve, companies IPO later, and pay programs take into account the more stringent governance requirements since the financial crisis. Experience shows that companies in the middle market, which have often deferred going public to a later stage of development, plan their IPOs one to two years beforehand, as part of their strategic planning process.

Companies meanwhile pay close attention to three critical junctures: a year before, the year of, and three years after the big IPO day. Start early and follow some general guidelines not to fall too far off course. ■

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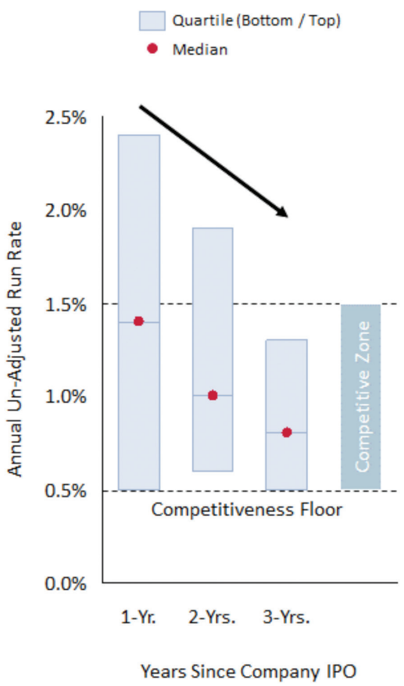
General guideline in equity pay strategy for IPO companies

Aim for an annual run-rate to be around 1% of common shares by the third year at current equity price levels



Source: Middle Market IPO sample 2010-2015, Company filings, SBCG analysis; not adjusted for fungible ratio
** Analysis excludes financial services, technology, special-situation IPOs*