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Establishing an Effective Equity Strategy as a Newly Public Company

ADVANCING THE DIALOGUE

WHAT'S THE BIG IDEA?

By taking a long view of your employee equity program, you can avoid the trouble that a more ad hoc approach creates—and reap significant talent and business benefits.

- The reactive approach to equity compensation taken by many newly public companies can lead to a number of unintended and suboptimum outcomes.
- An effective long-term equity strategy considers not just what is right for the business today, but also how today's decisions will impact the company in the future and to what extent the program will need to evolve over time.
- Companies that take a proactive approach and adopt the specific practices outlined in this article are more likely to effectively balance the interests of all stakeholders by avoiding potential pitfalls and distractions, ensuring appropriate levels of dilution, and maximizing the incentive and retention impact.

INTRODUCTION

Following an IPO, the outlook for employee equity programs changes overnight. The company instantly goes from a handful of investors to a diverse shareholder base. Governance requirements kick in. Regulators require significant disclosure of compensation and equity practices. Employee expectations shift. And as the company evolves, what worked at one stage doesn't necessarily work at the next.

With the heightened pressure on business results and the distraction of the myriad of new regulatory and governance requirements, long-term strategic planning around the employee equity program can take a back seat. As a result, many newly public companies take a reactive approach to managing their equity programs focused on current needs, without consideration to the long-term implications.

This ad hoc approach to managing employee equity awards runs some real risks. Dilution levels can swell and become an issue with shareholders, creating challenges for future shareholder votes (e.g., Say-on-Pay votes or director elections). Gaps versus competitive market levels can create problems with talent retention. Most importantly, perceived inequities and lack of transparency can distract employees from their primary mission—executing the new growth and business strategies.

To mitigate these risks and secure the benefits generated by a well-designed equity compensation program, you should strive to establish a long-term view that takes into account the different stages of company maturity. An optimal employee equity strategy requires long-term strategic planning that considers:

- **What is best for the business today?** Ensure that the program aligns with the current organizational dynamics and strategic priorities.
- **How will decisions today impact the organization in the future?** Anticipate the potential implications of increasing regulatory and governance requirements placed on public companies as they move beyond the IPO. Understand the extent to which decisions today will create constraints or challenges in the future.
- **How should the program evolve over time?** Plan for how the business and market dynamics might evolve and understand the potential implications for compensation design.

Companies that take this approach—proactive instead of reactive, strategic instead of tactical—are much more likely to avoid potential pitfalls, reduce unnecessary distractions, and maximize the incentive and retention impact of the program.

Understanding the landscape ahead

In the years following IPO, most companies face a number of business and market dynamics that have significant and direct implications for their equity program. The timing and degree of these different pressures may vary from one company to the next, but most companies face them to one extent or another:

- **Shifting shareholder base.** Over time, the shareholder base is likely to shift significantly—from venture capital and other early stage investors to larger institutions. These new investors usually have strong opinions on compensation related practices and often apply "one size fits all" guidelines in assessing pay practices. As the shareholder base shifts, the pressure to reduce dilution and adopt "performance-based" equity vehicles for top executives increases.
- **Moderating growth levels.** The high growth many companies experience leading up to and following an IPO is hard to maintain. To the extent that growth slows and valuation multiples decrease, your equity program can come under a lot of pressure. Stock options, which were once mechanisms for significant wealth creation, are underwater and discounted heavily by employees. Further, shareholders are less tolerant of high dilution levels given the slower growth.
- **Changing employee perceptions and expectations.** As a private company, employee focus is primarily on the upside and potential wealth creation of an IPO. Post-IPO, the value proposition as it relates to equity awards is often very different. Perception of potential upside is often much more muted and employees begin to prioritize vehicles with more certainty and tangible value like time-vested shares. This often changes how companies choose to denominate and communicate their grants as well (i.e., moving away from share denominated to dollar denominated grants).
- **Accelerating regulatory and governance requirements.** Newly public "emerging growth companies" are provided a grace period where certain public company requirements such as Say-on-Pay do not apply. After the exemptions expire, companies may find themselves with fewer degrees of freedom.

Companies are forced to modify their equity programs over time to ensure that they remain effective as their company and market realities evolve. The pace and specifics vary from company to company, but broadly speaking, this evolution takes the course depicted in Figure 1.

Table 1.
Stages of an Equity Program from Pre-IPO to Mature Public Company

PROVISION	PRE-IPO	AT/AROUND IPO	MORE STABILITY, SLOWER GROWTH	LARGE, MATURE COMPANY
Vehicle Use	Appreciation vehicles (i.e., stock options)	Mix of appreciation vehicles and RSUs	Mixed—heavier emphasis on RSUs; introduction of PSUs for executives	Heavy emphasis on RSUs and PSUs
Denomination	Number of shares / Percent of company	Mixed	Dollar value	Dollar value
Grant Timing	Large grant upon hire, sporadic practices otherwise	Begin transition to formal annual grant process (may top-up / refresh holdings for key EEsat IPO)	Formal annual grant process	Formal annual grant process
Participation	High level of participation ("Everyone participates" common in technology)	Mixed practices — highly dependent upon culture, share constraints, etc.	Participation reduced materially	Limited participation
Individual Differentiation of Grant Levels	Limited	Moderate	Significant	Significant
Total Shareholder Dilution	Moderate to High	Moderate to High	Low to Moderate	Low

Continually assessing where you are on the path and having a strategy for how you will move forward will allow you to implement a program that is optimized for your specific circumstances and minimizes the risks of future surprises or challenges.

Taking the long view—five best practices in equity strategy

Effective equity strategies require not only a long-term view but also careful execution and attention to detail. In our experience working with pre-IPO and newly public companies, we have found that the most successful companies keep their programs on track by adhering to these best practices:

ONE | Review and rebalance equity holdings at the time of the IPO. Pre-IPO, individuals are typically granted the majority of their equity when they're hired. As a result, the realizable and retentive values may vary materially across people with similar roles at the time of IPO.

The IPO offers an opportunity make sure that individual employee holdings are commensurate with their job level and expected future contribution to the success of the business. These adjustments should primarily be forward looking. The goal of these adjustments is not to correct past wrongs or reconcile all differences, but to correct situations that are clearly out of balance. To ensure that this rebalancing is fair—and that employees see it that way—it should be addressed with a structured, uniform approach.

Ensuring appropriate retention power following the IPO is critical. Employees whose holdings have greatly appreciated in value may be tempted to cash out. Further, a successful IPO makes your talent of great interest to other companies who believe that your people can do for them what they did for you.

TWO | Establish a formal structure and calendar. At or around the IPO, many companies, having approached grants sporadically in the past, move to an annual grant practice. The annual approach helps diversify the timing risk and layers retention value by increasing employees' equity holdings on a regular, predictable basis. There are also some cultures and business contexts in which larger, less frequent grants work well. Regardless of which approach you take, you should have a defined structure for grant timing, eligibility/participation, and grant calibration.

Be aware, however, that external stakeholders tend to look at pay in annual increments. More sporadic grant practices—even if based on a thoughtful rationale—are not compatible with their models and lead to more risk of external criticism. In particular, multiple grants or larger-than-normal grants in one year risk being viewed as outsized pay unless you have consistently articulated and followed a structure for how and when grants will be made.

Employees, too, prefer predictable grant practices. Part of the incentive and retention value of the equity program comes from employees knowing that they are likely going to get grants that are similar to those they received historically. If the timing is more ad hoc or the process opaque, they may discount potential future grants, which reduces the power of the equity program.

THREE | Prepare to ask shareholders to approve your equity plan after three to five years. Typically at the time of the IPO, equity plans have up to ten years remaining before they expire. Don't let this lull you into a false sense of security—many newly public companies are forced to return to shareholders for approval of their equity plan much earlier. The reasons are many: to ask for more shares, to ensure tax deductibility under 162(m), to eliminate provisions that are not viewed favorably by the investor community. Companies with "evergreen" features (a provision that provides for an automatic annual increase to the share reserve) are often able to postpone returning to shareholders a while longer. However, pressure from shareholders often forces companies to abandon these provisions well before their 10 year expiration.

Carefully consider how grant decisions are likely to affect how soon you will need to return to shareholders for approval of your equity plan. Additionally, consider how your equity program will be assessed when you do return. If you don't plan ahead, you could find yourself needing to return to shareholders earlier than expected with levels of dilution that are viewed critically.

FOUR | Establish and manage to target overhang levels. Dilution from employee equity grants is expected, but it must be managed carefully. Shareholders are generally more accepting of higher "overhang" (the cumulative potential dilution to which shareholders are exposed by grants to employees) levels around IPO, but expect them to be managed down materially in the first few years after IPO. To illustrate this trend, Figure 1 shows overhang levels for a group of almost 60 software companies with IPOs in 2010 or later. The median overhang for this group decreased by more than 20% in the two years following IPO and then stabilized at a steady state level.

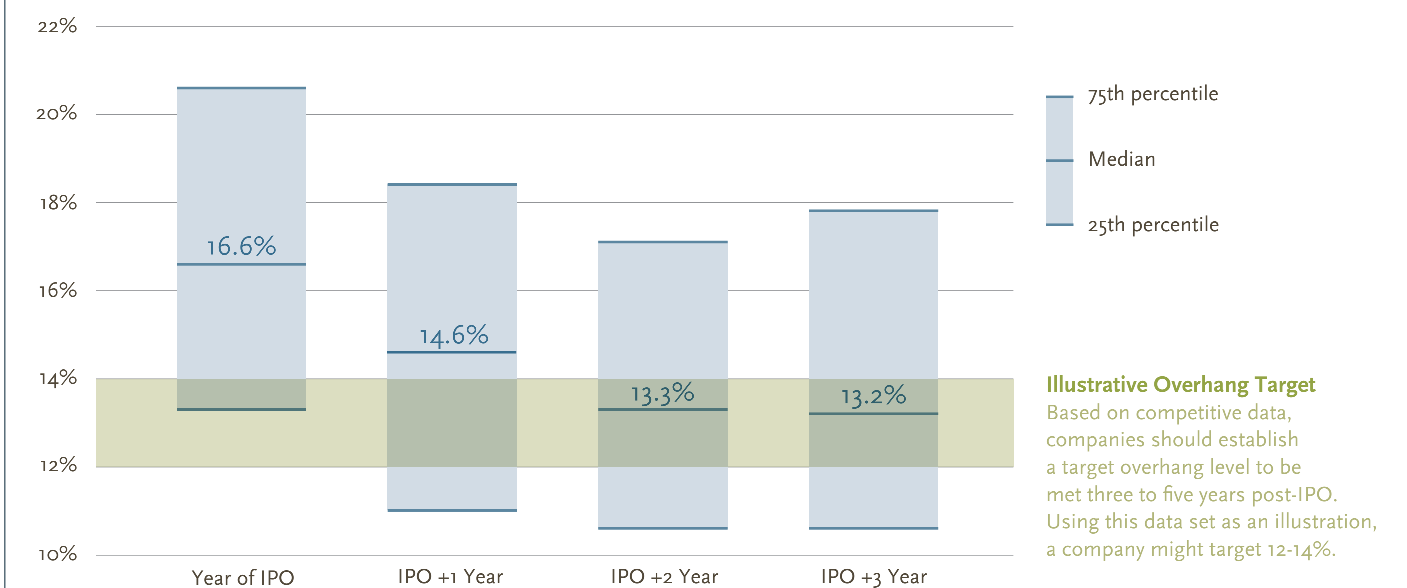
Don't wait until external pressures force the issue. Instead, model and plan for the cumulative impact of each grant. Grants today have the potential to impact your overhang for years to come and, in turn, your ability to make grants in future years. A two-step process can help ensure dilution levels are competitive and the company is well positioned for future shareholder votes.

First, establish a desired steady state level of cumulative overhang. Acceptable levels vary by industry, company stage, and growth trajectory. Analyze the overhang levels of your peers and understand what is considered acceptable by your largest shareholders. Based on these factors, create and manage to a target level to be achieved three to five years post-IPO.

Figure 1.

Establish a Target Level of Issued Overhang to be Achieved after Three to Five Years Post-IPO

Data reflects issued overhang levels from a group of 60 software companies with IPOs in 2010 or later.



Note: Issued overhang defined as the number of granted and outstanding full value shares and unexercised stock options as a percentage of common shares outstanding. Issued overhang does not include the number of shares available for future issuance.

Second, establish a target range for annual share usage ("burn rate") that is likely to result in the desired level of future overhang. In calibrating, you will need to consider different scenarios around stock price performance, head count growth, and stock option exercise activity. The goal is not to be overly precise, but to establish a reasonable range against which to manage. The resulting target range should also be tested against competitive levels to ensure appropriateness.

Figure 2.

Future Issued Overhang at Varying Annual Burn Rate Levels

annual burn rate	resulting issued overhang after three years		
	low case	moderate case	high case
3.0%	10%	11%	11%
3.5%	11%	12%	13%
4.0%	12%	13%	14%
4.5%	13%	14%	15%
5.0%	14%	15%	16%
5.5%	15%	16%	18%
6.0%	16%	17%	19%

Illustrative Annual Burn Rate Range
Determine a target annual burn rate range that would result in the target overhang three to five years post-IPO. In this illustration, a range of 3.5–4.5% would result in overhang levels consistent with the targeted range of 12% to 14% established in Figure 1.

Below target range
Within target range
Above target range

Note: Annual burn rate defined as number of full value shares and stock options granted each year as a percentage common shares outstanding.

This exercise should be refreshed annually to ensure grounding in the current internal and market dynamics. In establishing the targets, you should aspire to a level that you find to be acceptable for shareholders (by benchmarking overhang levels among your peers and industry), considers shareholder advisor policies (e.g., ISS and Glass Lewis), and can be achieved without jeopardizing your ability to attract and retain critical talent along the way.

FIVE | **Prepare for reductions in equity plan participation.** Simply stated, you will likely need to cut some employees out of the equity program in order to meet reduced dilution expectations. Wrestling with that reality is one of the biggest compensation challenges newly public companies face, especially for companies in the technology industry where there are strong cultural expectations that everyone participates. Some companies can avoid this for a few years if they can sustain high growth and valuation multiples. But for most companies, the reality of reducing participation comes sooner than they would like. And when managed poorly, it can come as a surprise—hurting morale and disrupting the plans of managers making compensation decisions.

By contrast, companies that take the long view think about equity participation not as a point in time, but from a multi-year perspective. They give themselves ample lead time to develop a comprehensive approach to reductions that includes:

How to cut—whether evenly across the employee population or through reductions by role, performance rating, or level in the organization.

Whom to cut—taking care to make sure that key talent and high performers have significant equity holdings, which is essential in today's talent market.

How to soften the blow—offsetting the reduced equity participation with salary increases, increased target bonuses, participation in an employee stock purchase plan, and the like.

When to communicate—signaling and explaining their intentions in advance, not only to the affected employees, but also to managers who oversee individual grant decisions.

Realizing the benefits of a well-designed equity strategy

By taking the long view and following the best practices above you can go a long way toward meeting the essential challenges of newly public companies: balancing the interests of all stakeholders to advance the business. The benefits of getting it right include:

- *Frees employees and leaders to focus on the business.*
- *Empowers the company to more effectively attract and retain top talent.*
- *Aligns incentives with the current strategic priorities.*
- *Avoids surprise and minimizes the risks of unintended outcomes.*

When executed carefully and with great forethought, an effective equity program creates a virtuous circle: carefully calibrated employee grants help attract key talent and drive growth and profitability, ultimately increasing the value of all shares, satisfying all stakeholders.

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