Equity Compensation: End-to-End Strategies for Private Companies

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Speakers

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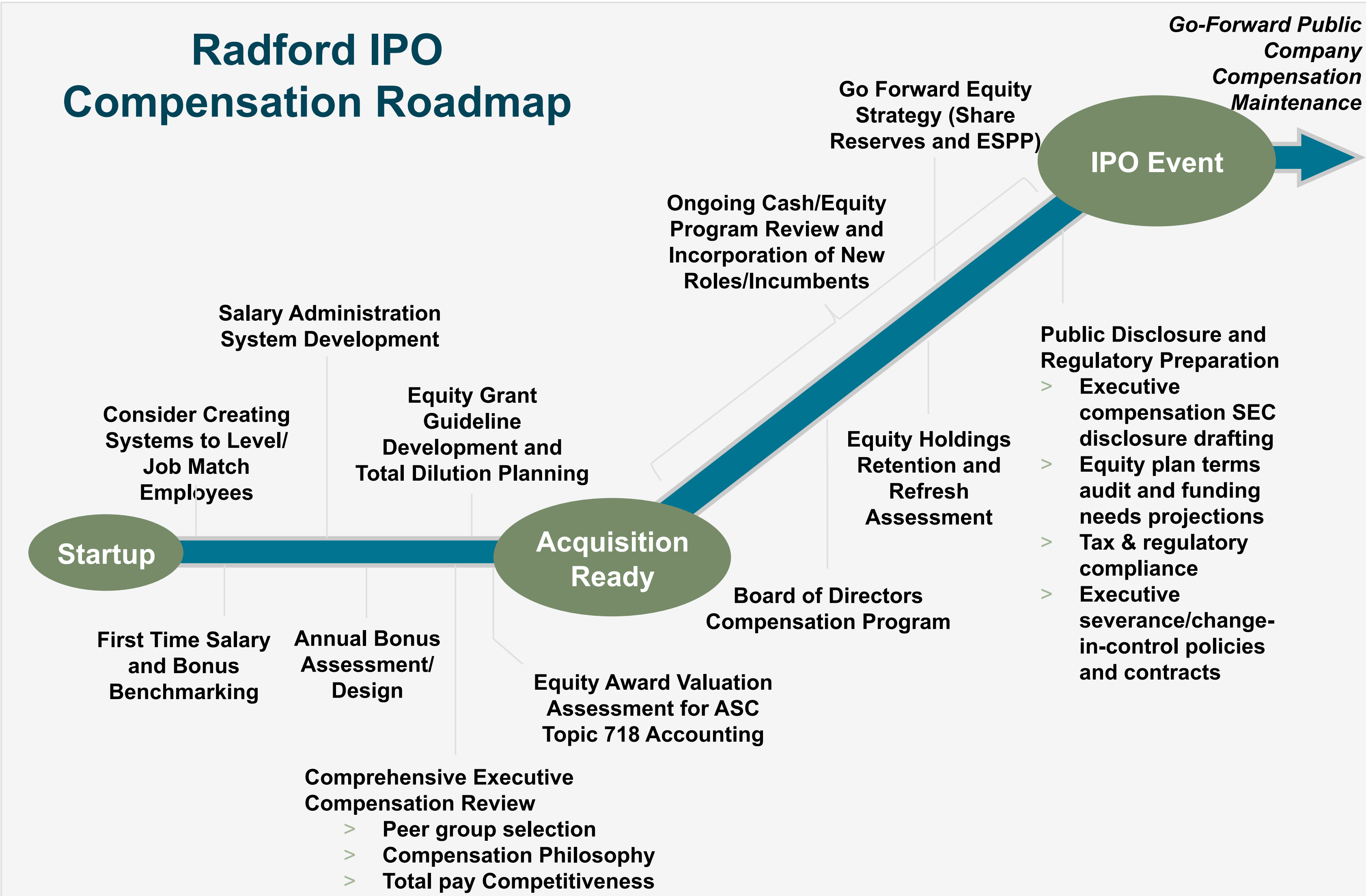
Agenda

- Equity Compensation Strategies
- Equity Compensation Tools
- Avoiding Stock Comp. Issues
- Key Strategies Prior to a Liquidity Event
- Q & A

Equity Compensation Strategies

Start by Identifying Your Stage of Development & Prioritize Accordingly



Source: Radford

Private vs. Public Company Pay Philosophies at a Glance

	Typical Private Firm	Typical Public Firm
Peer Group	> Usually, no specific identified peer list > Focus is placed on comparative companies similar in size and stage of development > Key metrics include industry, invested capital, revenue, stage of development and employee count	> Usually, a specific group of 15 to 20 identified public peer companies > Technology: focus is often on revenue and market cap > Life sciences: focus is often on market cap, R&D spend, product phase/stage
Cash Approach	> Base salary must be competitive *(no longer getting away with low cash)* > Annual bonuses a "definite maybe" these days	> Base salary: 50th percentile > Annual bonus: 50th percentile or above, emphasizing the at-risk nature of compensation
Equity Approach	> Aggressive award sizes, especially to those risking early entry > Vehicles: Stock options dominate > Award sizing metric: Ownership percentage	> 50th percentile and up to 75th based on performance > Vehicles: Options, RSUs, performance shares > Award sizing metric: Value
Pay for Performance	> Egalitarian: "we're all in this together"	> Pay is targeted to key roles and high performers

Source: Radford

Private vs. Public Company Equity Practices at a Glance

	Typical Private Firm	Typical Public Firm
Award Sizing	> Primarily established by targeting specific ownership percentages; conversion into shares based on TCSO	> Primarily established by targeting specific values; conversion into shares is based on stock price
New-Hire vs. Ongoing	> Large new-hire grants > Ongoing grants delayed until IPO approaches, or 3-4 years after hire > Ongoing guidelines set anywhere from 25% to 33% of new-hire awards	> New-hire awards are typically 2x ongoing award sizes > Most employees are eligible for ongoing awards after one year of service
Vehicle Mix	> Stock options dominate ***(A few notable companies used RSUs pre-IPO; however, cash reserves are needed to address taxes)***	> Mix of stock options and RSUs, with an emphasis on RSUs as the firm matures > Rising prevalence of performance shares for executives
Participation	> New hire awards: nearly 100% > Ongoing awards: targeted at key performers and those employees greater than 50% vested (usually 25% to 30% of population at any given time)	> New hire awards: participation drops as companies increases in size > Ongoing awards: broad eligibility is maintained, although awards targeted at top performers (usually 40% to 60% of population at any given time)

Source: Radford

Ask Yourself:
Where Are There Retention Gaps?

- **A snap-shot of current private company equity models:**
  - Large equity grants are made at the time of hire, typically with 4-year vesting
  - Refresh grants *may* occur in year 3 or 4, often set to 25% of new-hire grant levels
  - Refresh grants are *usually* offered only to top performers and critical roles (~25% of employees at any given time)
  - Employees are often very heavily vested by the time of an IPO, creating post-IPO retention concerns

Parameter	Time of Hire	Year 1	Year 2	Year 3+	IPO at $12.00
Equity Grant	400,000	-	-	100,000	-
Exercise Price	$0.25	-	-	$6.00	-
Vested Shares	-	100,000	200,000	300,000	400,000
Unvested Shares	400,000	300,000	200,000	100,000	100,000
Vested Paper Value	NA - no market until IPO				$4.7MM
Unvested Paper Value					$600K

Source: Radford

Equity Compensation Tools

The Long March of Equity…
Your IPO is Just the Start

Long-Term Incentive Vehicles	Startup	Mid-Cap/ Growth Market	Mid-Cap/ Mature Market	Lg. Cap/ Mature Market	Objectives/Implications
Stock Options Only					> Provides focus on absolute stock price growth and future upside potential
Restricted Stock or RSUs Only					> De-emphasizes stock price growth > Supports employee retention and ownership; especially at slower growth companies
Mix of Options and Restricted Stock or RSUs					> Combines stock price growth incentives with greater emphasis on employee retention and ownership
Performance Shares					> Allows companies to introduce specific performance-based contingencies into equity awards
Long-Term Cash					> Requires maturity and cash reserves, and often the ability to select metrics/set goals over time (e.g., 3 years)
Relative Total Shareholder Return					> Reflects institutional investor perspective (portfolio performance) > Maturity of market required for reliable comparator group/index

Most Common Practice **Emerging Practice** **Least Common Practice**

Source: Radford

Pros/Cons Equity Compensation Types

	Pros	Cons
Stock Options	• No immediate dilution • Employee controls tax event	• No retention value for underwater options • Complex valuation
Restricted Stock	• Ownership in stock from time of grant • No underwater issues	• Tax at vesting • Higher comp expense (than option) • Immediate dilution
Restricted Stock Units	• May settle in cash or shares • No underwater issues	• Tax at vesting • Higher comp expense (than option) • Possible liability accounting
Performance Awards	• Goal-based behavior • Shares only issued if performance met	• Tracking targets • Probability accounting • Changing targets = modification

Avoiding Stock Comp. Issues

Avoiding Cheap Stock Issues

- **Cheap stock charges**
  - Results from the issuance of private company share-based payment awards with exercise prices below the fair value of the stock
  - Typically arises in connection with employee stock options

- **Potential consequences**
  - Employee tax penalties
  - Administrative challenges
  - Higher stock-based compensation expense
  - Disqualified ISO status
  - SEC scrutiny during IPO process

Avoiding Cheap Stock Issues (cont'd)

- **Recommendations**
  - Obtain 409A valuations
    - At least once per year & more often with significant events
    - Should be contemporaneous
    - Best when prepared by independent valuation specialist
  - Document estimates of FV at each major grant date
  - Limit the number of grant dates in a given year
- **Tips**
  - Consult your auditors for 409A valuations specialists
  - Refer to AICPA Practice Aid on valuing private company stock
  - Obtain 409A at each major grant in the year leading up to IPO

Caution: Modifications

- **Modification by definition** (ASC 718-20-35-3)

  A modification of the terms or conditions of an equity award shall be treated as an exchange of the original award for a new award.

- **Recognizing modifications**
  - Repricings
  - Exchange of equity awards (e.g. options for RSUs)
  - Extension of time to exercise post termination
  - Acceleration of vesting
  - Change in performance-based metrics
  - Changes in employment status (e.g. consultant to employee)
  - Adding “change of control” provisions

Caution: Modifications (cont'd)

- **Modification implications**
  - Additional stock-based compensation expense
  - Possible tax consequences
  - Potential loss of ISO status

- **Tips & Suggestions**
  - Understand accounting and tax implications prior to board approval
  - Ensure equity software calculation is correct
  - Document all modification accounting

Priority #1 – Data Integrity

Key Questions

1. Are awards granted reconciled to board minutes at least once per quarter?
2. Have all recipients been properly identified in the system and either employee or non-employee?
3. Are employees notified of their awards on a timely basis?
4. Is the paperwork kept in a single location and is it complete?
5. If performance-based awards were granted, who is assessing probability?
6. Has the accounting department been notified of all award modifications?
7. Are taxes withheld for all exercises of non-qualified stock options?
8. What process is in place to ensure that employee terminations are entered into the system promptly?

ASC: 718 vs. IFRS 2

- Classification
  - Equity vs. Liability
- Grants
  - Grant Date Definition
  - Employee vs. Non-Employee
- Attribution
  - Straight Line or Tranche by Tranche
- ESPP
  - Non-Compensatory or Compensatory
- Income Tax Accounting
  - Deferred Tax Asset Measurement
- Payroll Tax Liability

Key Strategies Prior to a Liquidity Event

Thinking About Pre-IPO Equity Compensation… There's a lot to Consider

- Defining your post-IPO equity pool size
  - Evergreen provisions?
  - Employee Stock Purchase Plans?
- Awarding Equity in a Fair and Appropriate Manner as an IPO Approaches
- Transitioning Programs and Employees From Private to Public Environments
  - % of Ownership Becomes Value
  - Stock Options Often Become RSUs
  - Share Counts Often Decline
  - Award Frequencies Change
- Lock-Out Periods and Employee Communication
- Plan Administration

Common Equity Program Modifications at IPO

Practice at IPO	Technology	Life Sciences
New Equity Plan Adoption (% of companies)	89%	88%
Prevalence of Full Plan Evergreen (% of companies)	70%	83%
Median Evergreen Funding Rate (% of post-IPO total common)	4.0%	4.0%
Immediate Funding w/ Evergreen (% of post-IPO total common)	6.6%	6.4%
Immediate Funding w/o Evergreen (% of post-IPO total common)	10.0%	11.4%
Adoption of ESPP Offering (% of companies)	32%	62%

Source: Radford

Option-Only Approaches Still Dominate the pre-IPO Landscape

- Equity portfolio practices rarely shift until after an IPO

Employee Level	Pre-IPO Technology			Public Technology		
	Options Only	RS/RSUs Only	Both	Options Only	RS/RSUs Only	Both
Executive	95%	1%	4%	15%	24%	62%
Management	95%	1%	4%	20%	42%	38%
Professional	95%	1%	4%	21%	46%	33%
Support	96%	1%	3%	24%	40%	36%

Source: Radford, 2012 Global Technology and Pre-IPO/Venture-Backed Surveys

Pre-IPO Firms Focus on Time-Based Vesting Ahead of Liquidity Events

Employee Level	Pre-IPO Technology			Public Technology		
	Time-Based Vesting	Time + Perf. Accel.	True Perf. Vesting	Time-Based Vesting	Time + Perf. Accel.	True Perf. Vesting
Executive	80%	20%	0%	86%	10%	34%
Non-Executive	100%	0%	0%	98%	2%	8%

- Please note prevalence data may not add up to 100%, as companies may have multiple types of equity awards in place at the same time
- Investor pressure, media scrutiny and increased disclosure requirements have forced public companies to improve pay/performance links via true performance contingent vesting – but usually only for executives

Source: Radford, 2012 Global Technology and Pre-IPO/Venture-Backed Surveys

Change in Control

- Definition typically requires change in more than 50% of the voting power of stock
  - Definition in documents will most likely cover a merger, acquisition or IPO event
  - Conform definitions across equity plans
- Accelerated Vesting
  - Single- Trigger
    - Retention Strategies
    - Most common if no conversion
  - Double-Trigger
    - Employment Agreements

Section 409A

- Section 409A issues:
  - Stock Options granted at a discount
    - Stock Option cannot be an ISO if not granted below fair market value
  - RSUs
    - RSUs can be used to delay recognition of income tax
    - Note that FICA due at vesting
- Distributions on a Change in Control
  - Section 409A definition is technical and thresholds (which are adjustable upward) will need to be reviewed
  - Double-Trigger may provide more flexibility for the definition of Change in Control, as distribution occurs at the separation
  - Exemptions
    - Short-Term Deferral
    - Separation Pay

Section 280G

- Excess Parachute Payments may be subject to penalty
  - 20% excise tax to the individual
  - No compensation deduction to the company
- "Parachute Payment"
  - Compensation paid contingent upon a Change in Control
    - Includes accelerated equity vesting
  - If payment is greater than 3x average base compensation over past five years, "excess" above the base compensation amount is the parachute payment
- Private company exemption if shareholder approved

Securities Laws

- Federal
  - Private: Rule 701
    - $5M rule
  - Public: Form S-8
  - JOBS Act
- State
  - Blue Sky Laws (most incorporate Rule 701 by reference)
  - California has specific laws apply (See 25102(o))

Public Disclosure Provisions

- Executive Compensation Table
  - Grant date fair value of equity awards + other compensation
  - Individual grant details (shares, price, etc.)
- Compensation Discussion & Analysis
  - Compensation strategies & philosophies for equity awards
  - Note: JOBS Act exemption for emerging growth companies
- Beneficial ownership table
  - Aggregate of direct and indirect ownership
  - Significant shareholders (5%+)
  - Executive officers and board members

Public Disclosure Provisions (cont'd)

- Notes to Financial Statements
  - Plan summary / roll-forward
  - Stock-based compensation information
  - Details of equity awards by grant date in year prior to IPO

- Disclosure of Material Compensatory Arrangements
  - Material compensation plans, contracts or arrangements, or material amendments and modifications
  - Four business days to file, unless exception applies

Questions?

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