ROADMAP TO AN INITIAL PUBLIC OFFERING

Executive Compensation Fundamentals for Venture-Backed and Pre-IPO Companies in Technology and Life Sciences

By David Knopping, Vice President, Courtney Yarusso, Consultant and Alex Cwirko-Godycki, Senior Research Consultant

The IPO Window is Open

Although the wounds of the last recession are far from fully healed, the initial public offering (IPO) pipeline in the United States is once again alive and well. According to data published by The Wall Street Journal and Dow Jones VentureSource in mid-April 2011, the active ventured-backed IPO pipeline, which continues to grow with each passing week, is already approaching a count of 50 companies.[1] And of these firms, nearly 57% are in the technology and life sciences sectors. What's more, a regional look at the IPO pipeline shows traditional research and start-up hot spots have shifted into full gear. As of the study's publication, California hosted 53% of companies in the active ventured-backed IPO pipeline, followed by Connecticut, Illinois, Massachusetts and Texas, each with 7% of the pie.

However, despite the mostly positive IPO headlines generated by juggernauts like Facebook, LinkedIn and Groupon, the road to an IPO remains challenging and is arguably more difficult than ever before. The amount of time it typically takes firms to reach an IPO is stretching, growing over the past decade to a median of 8.1 years according to the same Dow Jones VentureSource study cited above. Additionally, enhanced scrutiny of executive compensation practices now means private companies must begin to govern pay in a manner consistent with public firms well in advance of entering public markets. Indeed, because of issues like these – coupled with the fact that private firms are often expected to have business models that can reach profitability and significant revenue growth prior to going public – we can safely say many pre-IPO firms are now being managed with a new level of sophistication comparable to public companies.

With this sea change in mind, the following article examines several executive compensation fundamentals for pre-IPO firms in the technology and life sciences industries — topics including the formation of an over-arching compensation philosophy, developing peer groups, and how best to balance compensation risks and rewards ahead of an IPO. Most importantly, we take a long-term view toward each of these issues, focusing specifically on the transitional needs of private companies as they face increasingly overextended run-ups to initial public offerings.

Building an Appropriate Foundation

One of the first items to tackle when designing a firm's core compensation programs (whether for executives or the general employee population) is the development of a comprehensive compensation philosophy. This philosophy will serve as a base for establishing and streamlining pay practices and it can provide context for answering questions around how to most effectively and strategically position pay for all employees. Furthermore, as a company grows and begins to ramp-up hiring, compensation philosophies can become an important asset in attracting new talent. Companies with a reputation for fairness and consistency are often firms with established and easily communicated core compensation values.

Despite the boilerplate language commonly found in the proxy statements of most public companies, Radford encourages clients to avoid a one-size-fits-all approach to writing their compensation philosophy. Every company should take time to carefully develop a philosophy based on existing values and cultural norms within the firm. When working with private companies, we typically counsel clients to adopt a questions-based approach to philosophy development, starting with the items listed in Figure 1 below. A wide-ranging philosophy discussion, involving leaders from multiple departments, will help private firms avoid the headaches generated by tackling issues on an as-needed basis in the run-up to an IPO. Additionally, firms will likely be best served by allotting time for separate discussions on executive and broad-based employee compensation issues, as answers to the questions below may vary for each group.

Compensation Philosophy Development Questions for Pre-IPO Firms

Figure 1

1. What are some of the core values you want your compensation philosophy to support? (Teamwork, fast decision making, flexibility, action orientation, process orientation, work-life balance, etc…)
2. What behaviors and outcomes do you believe each element of pay is intended to support?
3. To whom do you compare yourselves against in the marketplace? To what extent do you want to match their offerings? Relative to your peers, what are areas of strength you can leverage?
4. Do you recruit locally, nationally or globally?
5. How will compensation programs vary by job level, function or region?
6. Compared to equity, how important has cash compensation been in recruiting and retaining executives and key employees? How do you feel this might change over time?
7. Where do you want to position pay for executives and key employees relative to your peers or industry? Do you have a clear plan for how to communicate why each element of pay is positioned as it is?
    a) Base salary
    b) Annual incentive plan targets
    c) Long term incentives (cash and/or equity)
    d) Target total direct compensation
    e) Benefits
    f) Career development/ training
8. How might the positioning of each pay element vary for top performers, rising stars and key contributors?
9. How important are the principals of egalitarianism or internal pay equity to your culture?
10. Beyond traditional forms of cash and equity compensation, what other benefits do you believe are critically important to the company you intend to build? (Health and wellness, on-site child care, etc…)

Of course, as companies begin to evaluate each of the questions cited in Figure 1, they will quickly discover few of these items remain fixed over time. As firms transition to the public sector, elements of their compensation philosophy will almost certainly change. For example, the availability of cash may increase, which may allow a company to increase base salary and bonus levels relative to its peers. Furthermore, as an IPO approaches the potential for increased shareholder scrutiny may force firms to narrow the scope of equity compensation programs. To remain relevant, compensation philosophies need to adapt to these changing forces. Eventually, one would hope that a company's compensation philosophy becomes a key aspect of its DNA. Like a product roadmap, it should become the firm's total rewards roadmap.

To get ahead, we encourage companies to take on the challenge of formalizing an initial compensation philosophy at least six months prior to their IPO, if not somewhat sooner. As discussed above, companies should then be prepared to review and amend their compensation philosophy periodically. This is especially true just before an IPO when conditions surrounding the hiring and retention of employees are likely to shift dramatically. Adding further pressure to update compensation philosophies just before an IPO are changes in the make-up of a firm's key investors. Pre-IPO venture capital and private equity backers will almost certainly have a very different point of view on compensation and risk than most post-IPO institutional investors.

As a final note, pre-IPO firms should be aware of the fact that Institutional Shareholder Services (ISS), which advises many institutional investors, currently reviews compensation philosophies when making recommendations for Say on Pay votes at public firms. Among the many factors it considers when reviewing pay-for-performance issues, ISS has been known to cite compensation philosophies targeting total executive pay above the 50th percentile of the market as problematic. Taking ISS policies into account is yet another factor to consider as firms approach an IPO.

Peer Group Selection at Pre-IPO Firms

To ensure the effectiveness of executive compensation programs, all firms, private and public, are best served by benchmarking executive compensation against a suitable comparator group. Only after selecting appropriate peers can companies begin the task of setting pay at appropriate levels relative to the marketplace.

When benchmarking executive pay at pre-IPO companies, Radford considers a very specific set of metrics to be most effective for peer group and/or compensation survey data selection. In the life sciences sector, we commonly focus on items like invested capital, research and development spending (R&D spending), stage of product development, number of employees, therapeutic focus and/or potential IPO value. At technology firms, invested capital, revenue, revenue growth, number of employees and/or expected market capitalization are typically considered. In most cases, more than one metric is used for peer group development, but rarely are all of the choices listed above used at the same time. In Figure 2 on the next page, we summarize common changes to peer group selection criteria as an IPO nears.

Once the appropriate financial metrics are chosen, Radford generally advises companies to select peers and/or survey data by finding other private firms who fall within a 0.5x to 2.0x range of the metric(s) under consideration. In this case, "x" equals the company's own value for a given metric. However, smaller firms may need to be more flexible when selecting peers to ensure a sufficient sample size. For example, they may opt to consider "all companies with revenues under $60 million developing educational software" or "all firms pursing oncology treatments with fewer than 50 employees with invested capital under $40 million". Of course, the emphasis placed on various metrics may shift as corporate goals change and as firms move closer to key events like an IPO or profitability.

Just before an IPO, employee head count, (projected) market capitalization, net income and specific competitors start to become much more important peer group selection factors. At this point, it is not uncommon for companies to significantly adjust the design of their peer group — often switching from the analysis of private company survey data to a detailed review of public company data. As might be expected, at all stages of company development, firms should aim to select peers in similar industries and with similar lines of business, a task that usually gets easier as firms and industries mature.

Companies should note that for executive compensation peers, it is not always necessary to restrict peer group selection by location. This is the case because the landscape for recruiting executive talent is often much wider than for general employees. However, companies may certainly choose to take geography into consideration, especially when sitting in regions known to have a high cost of living impacting the cost of labor (e.g., the San Francisco Bay Area and Boston).

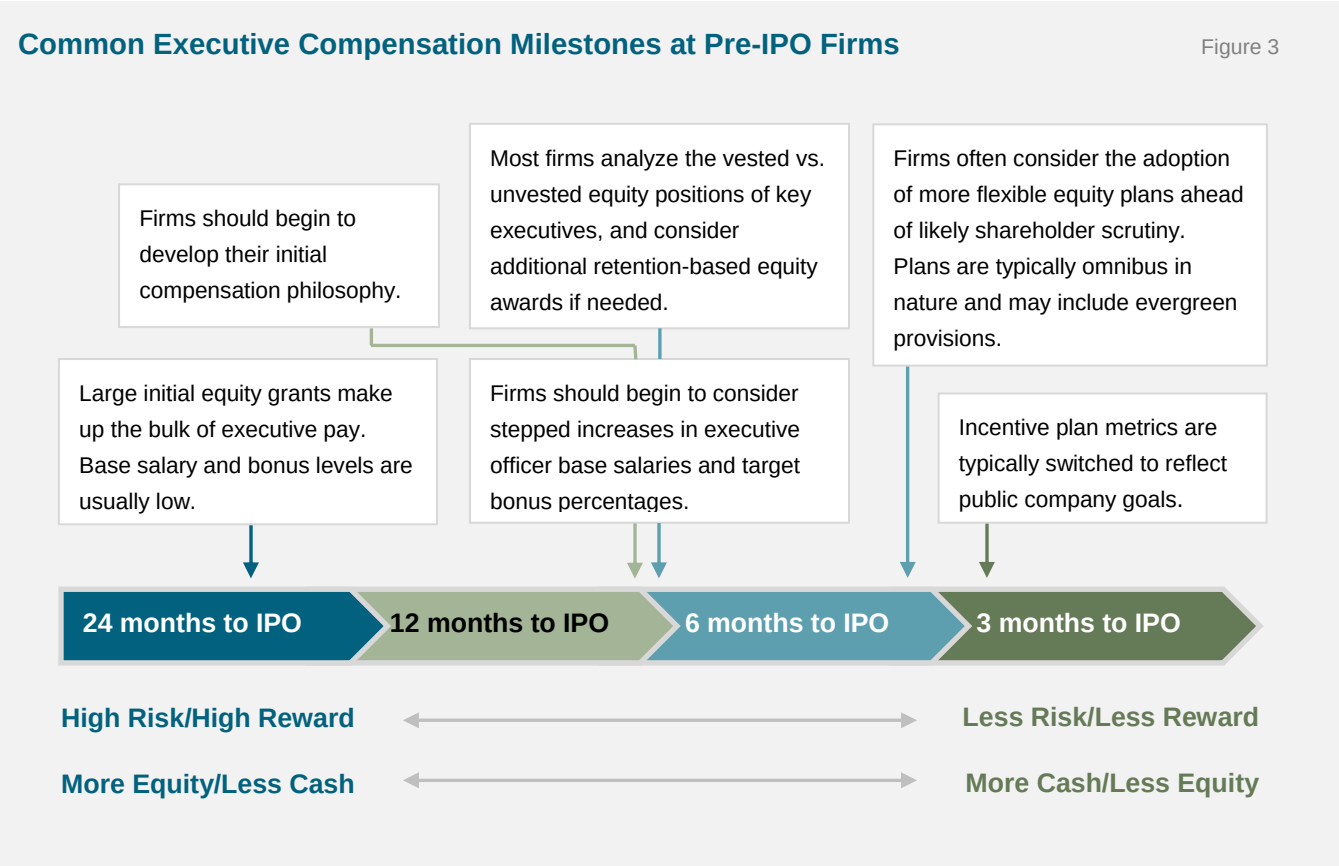
Managing Risk and Reward Ahead of an IPO

When it comes to paying executives, most early-stage private companies favor significant equity awards over cash compensation. Equity offers the promise of wealth, and, at a pragmatic level, it is usually more readily available than cash. Likewise, founding executives and early-stage employees typically accept a disproportionate amount of their compensation in the form of equity because of its upside potential and their desire to have a large ownership stake in the company they are expected to lead.

However, as outlined in Figure 3 on the next page, when an IPO nears, the balance between equity and cash compensation gradually begins to shift in favor of cash. Executives joining at later stages of company development take on less risk and thus usually have less opportunity for outsized equity awards. At this point, most internal guidelines for determining the size of initial equity awards for new hires require smaller grants. Meanwhile, base salaries begin to rise toward public company levels, ideally in a series of planned steps, and bonus targets, typically expressed as a percentage of base salary, also increase to ensure that an appropriate portion of pay is at risk and tied to performance.

Although still relatively small when compared to public firms, performance-based bonuses are becoming more prevalent at pre-IPO companies. Before going public, life sciences companies often measure performance based on the achievement of specific research, product and/or clinic trial milestones, and technology firms usually consider revenue or bookings as performance metrics. Of course, all companies must monitor their cash burn and

spending given the constraints on raising cash in today's economy. As an IPO nears, companies may choose to continue focusing on the metrics mentioned above. However, they might also begin to consider the introduction of bottom-line focused metrics more frequently found at public companies, performance measures like net income, earnings per share and relative or actual total shareholder return.



Even when companies do a good job of appropriately balancing risk and reward before an IPO, they must be mindful of post-IPO employee retention. As such, additional equity grants may be considered for tenured executives before an offering. Sometimes called "refresh" grants, these awards are especially important at 'older' firms where the run-up to an IPO has been long. In these cases, initial equity grants for founders and early employees may already be fully vested. Ahead of an IPO, companies should analyze the equity holdings of key executives to ensure that an appropriate balance between vested and unvested awards will be maintained both before and after the offering event, such that post "lock-up," employees still have an incentive to remain with the company.

Furthermore, as the median time between founding and going public continues to grow, more late-stage private firms have considered adopting equity grant practices similar to those found at public firms. In these cases, companies may opt for regularly scheduled annual equity grants to supply executives with a steady stream of wealth creation opportunity and retention glue.

Other considerations like shareholder scrutiny of overall equity usage (dilution) and the disclosure of pay for performance considerations should also shape executive compensation decisions at soon-to-be public firms. Just before an IPO, companies often evaluate the impact of a more restrictive equity environment, give themselves the flexibility to grant restricted shares and performance equity, and begin to set up processes to develop and review compensation disclosures.

Beyond the Fundamentals

In addition to the tasks illustrated in Figure 3 above, pre-IPO companies have numerous other compensation and corporate governance issues to consider before going public. These concerns, among others, may include employment contracts and change-in-control/severance protection for key personnel, 401(k) plan matches, loan repayment/forgiveness, Board of Director pay, employee stock purchase plans and the rethinking of core equity programs. Although not covered by this article, these issues are certainly not insignificant. On the contrary, when making a successful transition from private to public environments, thoughtfully engaging with all of these topics is critically important. Therefore, to help place this article into context with the full pre-IPO planning process, Appendix A includes Radford's complete pre-IPO checklist. While many of the items covered by the checklist are discussed in this report, we have saved others for future papers.

Moving Forward

For compensation professionals at pre-IPO companies, managing the path to a successful IPO requires careful planning and forethought. However, far too often, firms in a rush to cross the IPO finish line end up cramming one to two years of executive compensation program development into less than six months of time. This may adversely impact employee retention, hinder the development of appropriate incentive targets, and run the risk of angering future shareholders who are increasingly attuned to the governance of executive compensation. Taking a more long-term approach to transitioning pay programs from private to public environments will almost certainly reduce pain points and improve outcomes. Finally, starting with the core issues discussed above – compensation philosophy development, peer group selection and managing changing risk and reward profiles – will provide your firm with the proper foundation to tackle future executive compensation challenges.

To learn more about managing compensation programs at venture-backed and pre-IPO firms, please visit Radford's **Pre-IPO/Venture-Backed Pay Planning Portal** at http://www.PreIPOpay.com.

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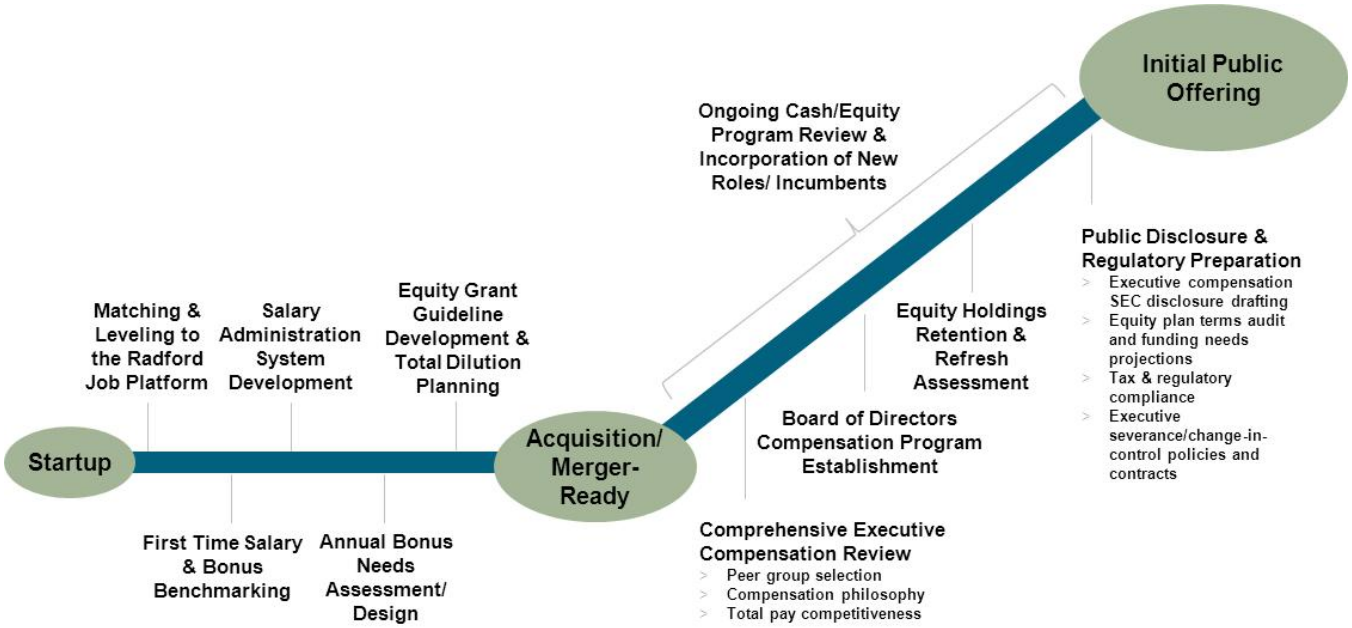
1. "A Look At The Venture-Backed IPO Pipeline" by Scott Austin, Wall Street Journal, 04/19/2011 http://blogs.wsj.com/venturecapital/2011/04/19/a-look-at-the-venture-backed-ipo-pipeline/

Appendix A: Radford's Pre-IPO Checklist

The timeline below provides a general overview of the process private companies should take when formalizing a compensation program.

Radford Pre-IPO Timeline



In conjunction with the above timeline, companies can also view the pre-IPO planning process as a series of key analyses and projects. Common action items include:

- ✓ Assess the overall retention value of equity programs, examining ownership levels for employees to determine if any adjustment grants should be considered prior to IPO.
- ✓ Review the cash incentive practices of public companies and begin to explore alternatives to align the program with market practices.
- ✓ Develop a peer list of publicly traded companies to be used to assess Executive and Board of Director compensation levels.
- ✓ Develop a compensation philosophy and a transition strategy to migrate compensation from private company to public company environments.
- ✓ Assess the competitiveness of the executive compensation program against approved peer companies covering salary, incentives and equity.
- ✓ Review current executive contractual arrangements (severance and change-in-control) and ensure they are consistent with peer and governance best practices.
- ✓ Review and design an equity strategy for the post-IPO environment covering the broad employee population, including potential evergreen provisions and ESPP programs.
- ✓ Implement a Board of Director compensation program that is consistent with public company peer practices.
- ✓ Draft and review a Compensation Discussion & Analysis Section (CD&A) to be filed as part of the S-1 Prospectus.

Contact Us

For more information, please contact:

Austin Office

Gary Starzmann, *Vice President*
+1 (512) 241-2120
gstarzmann@radford.com

Boston Office

Ed Speidel, *Senior Vice President*
+1 (508) 628-1552
espeidel@radford.com

Ted Buyniski, *Senior Vice President*
+1 (508) 628-1553
tbuyniski@radford.com

Rob Surdel, *Asst. Vice President*
+1 (508) 628-1551
rsurdel@radford.com

New York Office

Ram Kumar, *Asst. Vice President*
+1 (212) 441-2007
rkumar@radford.com

San Francisco Office

Linda Amuso, *President*
+1 (415) 486-7255
lamuso@radford.com

David Knopping, *Vice President*
+1 (415) 486-7122
dknopping@radford.com

Courtney Yarusso, *Consultant*
+1 415.486.7166
cyarusso@radford.com

San Jose Office

Brett Harsen, *Vice President*
+1 (408) 321-2547
bharsen@radford.com

Press Contact

Alex Cwirko-Godycki
+1 (415) 486-6973
acwirko@radford.com

Locations

Austin, Boston, Chicago, Hong Kong, London, New York, Philadelphia, San Francisco, San Jose, Singapore

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For more than 35 years, Radford has provided compensation market intelligence to the technology and life sciences industries. Global survey databases, which include more than four million incumbents, offer current, reliable data to nearly 2,000 clients. Leveraging Radford survey data, our thought-leading global Radford Consulting team creates tailored solutions for the toughest global business and compensation challenges facing companies at all stages of development. In addition to our consulting team, we also offer equity valuation assistance via Radford Valuation Services, and leading-edge market analyses and survey services with Radford Analytic Services. Radford's suite of surveys includes the Global Technology, Life Sciences, and Sales Surveys, as well as the US Benefits Survey. For more information on Radford, please visit http://www.radford.com/.

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