AGENDA

A Financial Times Service

In IPOs, Comp Committees Play Major Role

By Kristin Gribben February 3, 2014

This is the first article in a series of stories that examines the costs of going public from a governance perspective.

Developing executive compensation is no minor event in the life span of a company about to go public. And with 2013 producing the most IPOs since 2000, comp plan design is likely to become more of a focal point, as some analysts anticipate that favorable market conditions will mean more of the same this year.

"Any buyer will want to see good governance in place," says **Robin Ferracone**, CEO and founder of **Farient Advisors**. Ferracone has done extensive consulting for companies going through an IPO and has found it is increasingly important for private company boards to lay the groundwork for good governance before they initiate a public offering.

Executive pay also plays a pivotal role when a company is mulling a sale to a strategic buyer or looking to raise money through private investment, Ferracone notes.

"[Potential investors] don't want to see options backdating or restating earnings," she says. "The lesson here is directors [of private companies] need to really stay on point and behave as if they are public."

In fact, compensation plays such a big role in going public that it is actually the largest recurring cost, surpassing even SOX-related expenses, the accounting firm **EY** found. On average, companies spend an additional $2.5 million on non-recurring compensation charges, and, of that, $1.5 million was specifically related to executive pay. EY's study, published at the end of 2011, reviewed 26 companies that went public between 2009 and 2011 across eight industries with average revenues of $500 million.

"Many of these investments are ones you would make if you were growing, but it gets accelerated if you go public," says **Jackie Kelley**, EY's Americas IPO leader.

"The most important thing that investors look at when making an investment decision in an IPO company is the credibility of the management team…. So you do want to make sure that they see compensation programs that are going to drive performance," Kelley says.

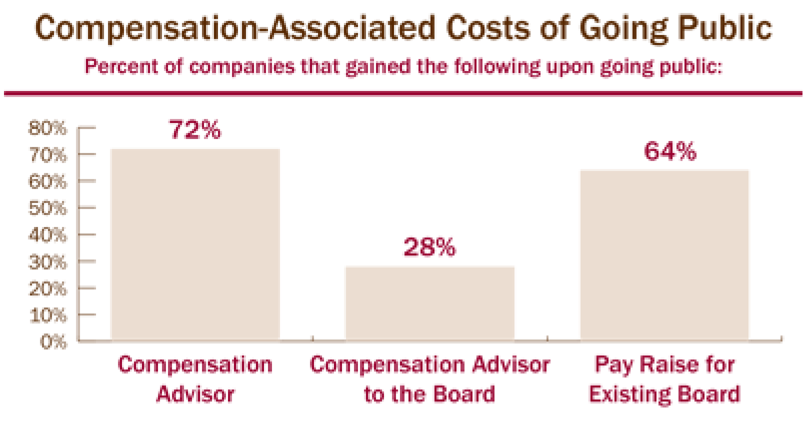
While the focus should ideally be on how to align pay for performance, there are outside influences that can weigh on a comp committee's decisions. A pair of **McKinsey** consultants came to the conclusion that, on some levels, public boards are more concerned with outside constituents' perception of executive pay than they are with ensuring the right alignment of pay for performance.

The consultants spoke with 20 chairmen or CEOs in the U.K. in 2008 about the differences in private versus public board life. Through those conversations they found public boards have more thorough discussions about compensation but also "seem more concerned about the reaction of external stakeholders to potential plans than about their impact on performance."

Ellen Siminoff, a director of several companies, including the newly public **Zynga**, as well as **US Auto Parts**, **Solarwinds** and **Journal Communications**, and **Mozilla**, a private foundation, says compensation is inherently more nuanced at public companies and that it's hard to set pay in a vacuum.

"There is a lot more complexity to being public. It makes sense for executives to get paid more," says Siminoff.

Ferracone says taking a company public means intent to grow, and that also demands higher pay. A newly public company will seek executive talent and benchmark its pay at the level of growth the company envisions in the near-term future, she says. "You're kind of setting the compensation ahead of the game a little bit."



Source: EY's True Costs of IPOs Survey, 2011

However, some observers caution against thinking going public automatically means higher pay. In fact, new research suggests that some private company CEOs get paid less while delivering superior performance.

The boutique compensation consulting firm **HR+Survey Solutions** found that private company CEOs at 19 **Blue Cross Blue Shield** affiliates received, on average, 25% less than their public insurance company CEO counterparts. But when adjusted per dollar, the private company CEOs delivered higher "premium revenue per dollar."

"There's a propensity for folks in general to think bigger is better…. So our default thought is these [public] companies are going to be more efficient," explains HR+Survey Solutions managing partner **Judy Canavan**. "This is interesting in that it shows maybe it's not more efficient."

Canavan says while it is logical to pay public insurance company CEOs more because their organizations are bigger, the BCBS organizations show that companies can attract talented executives without paying lucrative stock-based equity.

Simon Wong, visiting fellow at the **London School of Economics** and adjunct professor of law at **Northwestern University**, says it's important for a board to set expectations of the culture around compensation early on. He says some people make the mistake of thinking their CEO will only be motivated by compensation. Most CEOs aren't thinking they will only work harder with more pay, he says.

"It's not about, 'I'm going to work harder,'" he says. "It's, 'If I don't feel I'm adequately rewarded for my efforts against who I consider my peers, I might develop a degree of resentment.' If you feel resentful you might look at other opportunities."

To create a healthy compensation culture, Wong, who is a former management consultant at McKinsey, says executives need to look for other markers of success, like prestige and recognition from their peers.

Illustrating that point, Wong references a large U.K. company he spoke with where the CEO voluntarily cut his pay following the financial crisis. His direct reports followed suit. But even as the company's stock rebounded, the top management team chose to maintain a lower pay opportunity through their restricted stock awards because they felt the pay was excessive prior to the market crash.

One area of particular focus for boards about to embark on an IPO is evaluating whether the executive team fully appreciates how their role will change once the company has a more diversified shareholder base. Ferracone says this comes up often when a company is led by a founder-CEO.

"My experience is more founder-led companies have the hardest time not acting like the business is theirs."

Seasoned compensation committee members have observed that the world of public company executive pay has only gotten more difficult.

"The increased scrutiny makes you aware there are a lot of legal implications to every decision you make," Siminoff says. "You have to be aware of the perception."