PREPARING TO GO PUBLIC? FOUR CRITICAL ISSUES COMPENSATION COMMITTEES SHOULD CONSIDER

For companies preparing to go public, either through an initial public offering (IPO) or a merger with a publicly traded special purpose acquisition company (SPAC), there are several important and strategic compensation-related issues to consider. In our experience, the top four are:

1. The articulation of the compensation philosophy (including the peer group used to establish competitive pay levels and practices)
2. The design of the annual incentive program (where relevant)
3. The mix of equity to be granted to executives, non-executive employees, and board members
4. The share reserve structure

Define a philosophy that aligns with the organization's business and talent strategies

As a starting point, it is important to obtain collective agreement on the organization's approach to paying its executives, non-executive employees, and board members.

A compensation philosophy forms the foundation of a rewards program and is influenced by the company's unique business and people strategies. It should reflect the perspectives of the organization's stakeholders (e.g., board members, management, and major investors, where relevant) on how to attract, retain, motivate, and reward employees. The following are critical factors to be addressed:

- The market for talent (i.e., organizations with which you're competing for talent; typically within a similar industry and/or with similar size and growth characteristics)
- The positioning of pay (in total and by element) within that market for various levels of performance (e.g., paying at the 50th percentile for meeting expectations)
- The mix of cash and equity
- The mix of fixed and variable pay
- The desired level of pay variability (by employee, year, level)
- The desired level of employee choice/flexibility in the program
- The desired segmentation by employee level or function of all the above factors

Design an annual incentive program that aligns management with organizational success

In many companies preparing to go public, incentive programs are simple, discretionary, and ad-hoc, often due to the challenge of setting performance objectives early in the business lifecycle. In these instances, incentives are used more as a reward than a performance motivator.

As a company matures, establishing a more structured incentive framework with annual and longer-term components will reinforce organizational alignment with key performance indicators (KPIs). After all, you get what you pay for.

Performance Measures. When establishing an annual incentive plan (AIP), start with understanding your major success milestones and key financial indicators over the next 6–12 months and prioritize the most important 3–5 KPIs. For some organizations, setting annual objectives may be too challenging. In these instances, consider a quarterly or semi-annual bonus program, with a year-end true-up to manage variability.

Differentiation. Consider how much variability—in both performance and pay outcomes—is appropriate and how much, if at all, employees should be differentiated on their individual contributions (i.e., the relative weight on individual vs. corporate performance in the annual plan).

Pay for Performance. It is essential to scenario test the program under various performance conditions to ensure appropriate pay for performance alignment and identify potential affordability concerns (in which case, an earnings threshold level of performance may be required—often called a "circuit breaker").

Governance. It is also important to conduct a thorough review of how performance measures interrelate and incorporate sufficient governance features (e.g., payout maximums), to mitigate unintended consequences, such as employees making the "wrong" decisions on behalf of the organization solely to increase annual bonus payments.

Establish equity grant guidelines with a risk/reward profile that matches the business strategy and stage of lifecycle

Frequency. In establishing the equity strategy, many companies consider peer practice, expected share price growth, dilution, and potential market volatility. For example, some organizations set annual (or even quarterly) equity grant guidelines with overlapping vesting periods to smooth cash flow, increase the retentive value of outstanding awards, and manage dilution. Others may opt for multi-year "mega grants" on a less frequent basis to take advantage of lower strike prices in earlier years and/or to deliver the most competitive on-hire offer.

Eligibility. While the "equity-for-all" mindset may be common among pre-IPO companies, it may not be the most effective use of capital. In some cases, particularly for early-career employees who require greater certainty/liquidity, compensation delivered in long-term equity vehicles (which come with an element of risk) may be perceived to be less valuable than cash, even with future upside potential. It is important to understand (and not assume) what employees value most to inform whether eligibility for the equity program should vary by level and/or business function. This extra step ensures your pay programs deliver the optimal return on investment.

Vehicles. For equity plan participants, consider the appropriate balance of equity vehicles, shaped by the company's stage and growth trajectory and employee profile.

- **Stock options** tend to have a higher risk/return profile, require reasonable financial market knowledge, are more widely used within early-stage companies, and could provide a potential tax advantage for Canadian taxpayers.*
- **Restricted share units (RSUs)**, comparatively, offer more downside protection, include the accumulation of any dividends paid to shareholders, and are typically easier to understand for the broader employee population.
- **Performance share units (PSUs)** fall somewhere in the middle and are typically reserved for more senior employees within established organizations that can comfortably set long-term performance objectives.

**For more information on the recent Canadian stock option tax changes, see the Southlea Group article "Canadian stock option tax changes are here - what you need to know").*

Stock Option: a right to buy a share of the company in the future (once time restrictions have lapsed) at a stated fixed price. The value to the option holder is the appreciation in value of the stock only (not the full value of the share).

RSU: a notional interest in a share of the company which is restricted for a period of time (vesting). Upon vesting, the unit pays out as a share or the equivalent cash value.

PSU: an RSU where the ultimate number of units that vest at the end of the performance period may increase or decrease based on the achievement of other performance conditions (e.g., earnings growth)

Structure the equity reserve in a flexible manner, balancing talent recruitment/retention needs and responsible dilution

The approach to equity granting (frequency, form, mix, eligibility) will impact shareholder dilution and the longevity of the share reserve so it needs to be carefully modeled and considered under various share price performance and headcount growth scenarios to ensure there are no major surprises down the road.

Generally, it is important to incorporate as much flexibility in the plan as possible while ensuring it continues to have appropriate governance and dilution management features in place such that it is acceptable to investors and proxy advisors. Ensure the plan is written to incorporate multiple forms of equity (e.g., options, RSUs, PSUs, and DSUs) and settlement (cash or equity), even if you don't plan to use them all at the outset.

Among organizations going public on a Canadian exchange, it is a prevalent practice to establish a 10% share reserve. However, several factors should be considered in determining the size of the reserve, including peer/industry practice, investor profile and preferences, and other design features (e.g., the inclusion of practices like liberal share recycling and single trigger change in control may require an offsetting decrease in the size of the share reserve). The two most common ways to structure the share reserve are:

- **Fixed**. Articulated as a number of shares. This structure is more common among large, publicly traded companies and preferred by investors as shareholder approval is required once all reserved shares have been utilized (no time limit).
- **Rolling**. Articulated as a % of all common shares outstanding. This structure is considered to be more flexible, as the reserve is automatically replenished when newly issued shares are converted to common shares. This is particularly valuable for companies that expect to continue to issue shares in the near term. Shareholder approval is required every three years for TSX-listed companies and annually on the TSX Venture.

For companies going through IPO, the equity plan is deemed to be approved on IPO and not subject to a separate resolution. More liberal design features may often be embedded (provided they are supported by investors) and can be adjusted/eliminated prior to the first required shareholder approval in future years. For companies merging with a SPAC, the plan needs to be approved upon transaction; however, based on our experience, shareholders are more liberal in what they support in these instances, as compared to larger, more established publicly traded companies.

ABOUT US

As a trusted independent advisor to boards and management teams, Southlea offers fresh insights and perspectives on people and pay programs to enhance business results. This means working collaboratively with boards and management teams using a proven approach to align pay outcomes with the achievement of an organization's strategy and performance objectives.

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