

Building Wealth in the Executive Suite

Executive Compensation and the Board

Jeremy Anderson, Principal
Remedy Compensation Consulting

July 31, 2007

Today's agenda

What are the executive compensation issues that face employers and their boards as the company becomes publicly traded?

- ▶ Changes in the composition of the executive pay package
- ▶ Dealing with executives who are accumulating substantial wealth
- ▶ SEC impact on the executive compensation process
- ▶ Retention issues

Changes in the executive compensation package

Pre-IPO



Publicly traded

- ▶ Equity is the “pixy dust” that dominates the compensation discussion and profile
- ▶ Equity grants made upon hire and ongoing grants are sporadic at best
- ▶ Annual bonuses are modest and typically discretionary
- ▶ As IPO approaches, focus of program shifts to equity to allow executives to reap rewards

- ▶ Although certain industries focus on equity, companies seek balance between equity and cash rewards
- ▶ Annual bonus more likely subject to a formula and performance-based
- ▶ Creation of long term cash based incentive plans
- ▶ Annual FMV stock option grants provide most of wealth accumulation ability for executives

Executive compensation profiles

Pre-IPO



Publicly traded

- ▶ Total compensation package consists of the following (median of the group):

- Base pay \$269,680
- Target short term bonus \$94,630

- ▶ Equity grant or vesting data unavailable, but ownership percentage of the firm is:

- Founder—5%
- Non-founder—4.85%

- ▶ Total compensation package consists of the following (median of the group):

- Base pay \$403,750 (33% of total)
- Actual short term bonus \$145,285 (12% of total)
- FMV stock options which vested in the year \$665,205 (55% of total)

- ▶ Equity ownership percentage of the firm is 1.52%

¹ Source: 2006 Top Five Pre-IPO Life Sciences Survey Report

² Based on a sample of 2007 SEC filings for 8 life science companies with revenues ranging from \$45 to \$650 million

Programs change as companies mature

Our experience indicates that executive pay programs change as companies move through different stages of their existence

- ▶ Pre-IPO companies
 - Goals relate to product development and funding
 - Incentive programs are more likely to be discretionary
 - Large option grants to attract and retain executive talent and conserve cash

- ▶ Newly public companies
 - Goals relate to product development and financial metrics
 - Option grants moderate, as pay is measured against publicly traded peers

- ▶ Established companies
 - Goals focus on financial metrics
 - Option programs decrease, and are replaced by restricted stock and long term cash based incentive programs
 - Incentive programs are more likely to be performance based

Dealing with wealth (on paper) executives

Although executives can acquire great paper wealth due to the IPO, shares aren't often sold for a variety of reasons

- ▶ After a certain period of time, FMV options begin to lose their appeal
 - Legal restrictions on exercise
 - Investor relations implied restrictions on exercise
 - Lack of value when “underwater”

- ▶ Executives seek other forms of compensation
 - Increased cash bonus opportunities
 - Equity vehicles where risk is lessened
 - Restricted stock
 - Options that can vest faster if goals are attained
 - Vehicles that tie rewards to share price but pay in cash

SEC impact on executive pay

New proxy regulations have forced employers to make additional disclosure about their executive compensation programs and methods, and boards to be more involved

- ▶ Executive compensation process changes
 - Less reliance on CEO input regarding subordinate pay
 - Use of outside consultants
 - Use of peer companies

- ▶ Executive compensation program changes
 - More 'pay for performance'
 - Less discretion in hands of board for bonus awards if goals are not met
 - What will executives receive when they leave?
 - Can automatic grants/increases be justified?

SEC impact on executive pay

The additional disclosure is forcing boards to consider additional issues regarding executive pay

- ▶ What stake should an executive hold in the company—
 - Stock ownership guidelines
 - Equity grant guidelines
 - Restrictions on sale

- ▶ Is the company's compensation philosophy appropriate—should the company pay at a level that is in excess of its performance?

- ▶ The board's role in establishing and enforcing performance goals--
 - Executive input vs. peer group standards
 - Long term vs. short term—the longer the term, the harder to establish
 - Penalties for failure
 - Claw backs

Retention issues

How does a company retain key employees when they have become wealthy (on paper) as a result of the IPO?

- ▶ Employment related issues
 - Employment contracts—can you keep executives around if they have vested options that are ‘in the money’
 - Change of control programs—how do you keep the executive team together and focused on running the business if a deal is in the works
 - Restrictive covenants

- ▶ Incentive plan design helps aid retention
 - As publicly traded companies move away from discretionary bonuses, performance based equity programs with clearly stated metrics demonstrate to investors that “pay for performance” exists
 - Long term cash based programs may provide an answer to the executives’ liquidity needs and the company’s retention needs

Questions?

For further information, feel free to contact me directly ...

Jeremy Anderson

Remedy Compensation Consulting

152 N. Cedros Ave.

Solana Beach, CA 92975

(858) 484-3636

janderson@remedycomp.com

www.remedycomp.com