C-SUITE

An Equilar publication
Issue 36, Summer 2021

The View From the Top

An interview by Steven Borden with entertainment industry icon and corporate board veteran Debra L. Lee

Going Public

Key compensation issues in preparing for an IPO or SPAC merger

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Last year, for the first time, U.S. companies raised more than $100 billion through initial public offerings (IPOs). In addition, 2020 saw a marked increase in the use of Special Purpose Acquisition Companies (SPACs) as an alternative route for taking companies public. SPACs have exploded in popularity over the past few years due to their significant advantages over traditional IPOs, such as faster timelines, lower costs, easier information dispersion and greater access to capital.

IPO vs. SPAC

The principal purpose of an IPO or SPAC is to take a privately held company public. IPOs accomplish this objective by selling shares in a privately held company to the public. On the effective date of an IPO, the new public company's shares are listed and traded on a national securities exchange. IPOs can help raise capital, reward stakeholders and early investors, and build brand awareness, but they often involve a long and complicated process that can be expensive.

SPACs accomplish the objective of taking a private company public in a different way than IPOs. As explained in more detail below, a SPAC is already a publicly traded company used for the acquisition of a privately held operating company. The acquired privately held operating company is merged into the SPAC, hence becoming a publicly traded company.

What Makes SPACs Unique

SPACs are publicly traded shell companies created for the sole purpose of acquiring a private company. SPAC founders (or sponsors) are usually private equity investors, successful bankers or former industry executives who provide modest start-up capital for the SPAC. Once funded, a SPAC goes through a relatively small-scale IPO process by registering its shares with the Securities and Exchange Commission, securing underwriting and offering SPAC units (shares) to the public. SPAC management will then look for potential acquisition targets of privately held operating companies.

Unlike an IPO, where investors know exactly what they are investing in, SPAC investors may only know the SPAC's possible targets. As one investor put it, "An IPO is basically a company looking for money, while a SPAC is money looking for a company."[1] Some SPACs target companies within specific industry sectors or companies of particular revenue or asset size, but many do not. An investment in a SPAC is an investment in the leadership team's ability to successfully find and acquire a target company with significant value creation potential.

Unlike IPOs, a SPAC has two years from the time it is established to make an acquisition. If the two-year period ends without a successful transaction, the investors are reimbursed their respective investments. If an acquisition is completed, SPAC units are converted into shares of the acquired company. This transaction launches the "de-SPACing" process, by which the private company and its operations, leadership teams, products and services merge with the public entity SPAC upon which the SPAC changes its name and ticker symbol to reflect the new company. Founders usually realize a substantial return on their investment.

A SPAC may approach a target company that meets specific criteria and offer a merger, subject to the approval of SPAC investors. Rather than having months or years to prepare for a traditional IPO, a SPAC timeline could be as short as a few months. In our experience, because target companies of SPACs may not be planning to be publicly traded in such a short timeframe, it is often the case that SPAC target companies do not have mature and fully market-competitive compensation structures. They depend on the SPAC to establish processes to prepare for a public company compensation structure, often an enormous challenge for young companies to achieve in the span of just a few months. The primary area of focus is often the company's equity grants in connection with the transaction and beyond, as further detailed later in this article.

Preparing a Public Compensation Structure

In preparation for becoming a public company, a critical step is calibrating the executive pay program to both support the business strategy and to be competitive with other public companies of similar size and industry to attract, motivate and retain key talent. Understanding the prevailing market practice in terms of executive pay levels and structure, incentive design and other key features helps inform how compensation may need to change to become market-competitive (often over time), align with shareholder expectations and corporate governance standards, and support the company's strategy.

Establishing a market reference group that includes 15 to 20 well-established and publicly traded "peer" companies typically forms the market backdrop for these compensation decisions. Companies in a peer group should have any number of attributes in common with the SPAC acquired company—company size (annual revenue, market capitalization, head count), industry, geographical footprint and more. Compensation details for these companies are publicly disclosed, and when reviewed in aggregate, provide key insights into market-competitive pay levels, designs and practices. Further data can be gleaned from compensation survey databases which can be filtered based on the industry and size of the company. This market information provides important directional context and guidance for the new board of directors and the management team in thinking about the appropriate compensation programs going forward.

Companies should also create a go-public transaction peer group. These transaction peer companies may not be as directly comparable along the dimensions mentioned above, but they are representative of newly public companies that have recently established equity compensation plans, sometimes with special initial awards tied to the transaction. This data helps inform how much equity is commonly reserved and allocated upon becoming a public company as well as other equity design features that are unique to newly public companies.

Key initial decisions on salary, annual and long-term incentive levels and design are often tackled in advance of becoming a public company so that these specifics can be shared with employees. There are several secondary considerations for companies preparing to go public, such as stock ownership guidelines, a clawback policy, and severance and change-in-control protections. Stock ownership guidelines specify what the company expects the CEO and next-tier executives to hold in equity to ensure that their interests are aligned with shareholders. Clawback policies protect the company and its shareholders in the event of a financial reinstatement, fraud or executive misconduct. Severance compensation is a means to fairly transition employees out of the company while protecting the business and shareholders by requiring the transitioning employee to comply with certain restrictive covenants post-employment. As such, some companies establish an executive severance plan as part of the initial preparation activities rather than as a secondary activity.

Equity Compensation

A featured component of public company executive compensation is equity awards. Many companies will make an initial equity award to employees in conjunction with a go-public event, and then begin a pattern of regular annual equity awards to executives and other key employees thereafter. Equity compensation is critical for aligning employee interests with those of shareholders, ensuring appropriate compensation outcomes with execution of longer-term company strategy and establishing meaningful retention incentives.

To award equity-based compensation, a SPAC-acquired company will be required to establish a shareholder-approved equity incentive plan and an appropriate-sized share reserve. An equity incentive plan enables the newly public company to grant to executives and other key employee permitted award types (e.g., stock options, stock appreciation rights, stock units and restricted shares). In addition, an equity plan will include the size of the share pool from which equity

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awards are granted (the share pool may be subject to an evergreen provision), the treatment of equity awards upon certain terminations of employment and a change in control, and other administrative and governance provisions.

> **There is a tremendous amount of work required to prepare an organization for life in the public markets.**

There are a number of key provisions to consider when establishing the equity plan, such as provisions relating to one-year minimum vesting, plan administrator's discretionary ability to accelerate vesting, share recycling, evergreen provisions and others. Many newly public companies opt to create an initial equity plan that incorporates greater administrative flexibilities through these various plan features, with the understanding that these provisions may change in the future. Close collaboration with outside advisors can help a company tailor an equity plan to meet its specific needs and shareholder expectations at the time of its go-public event.

Most commonly, newly public companies grant full-value shares (i.e., restricted stock or restricted stock units) and stock options that vest based on continued service to the company and/or the achievement of specific performance criteria. In our experience, the prevalence and prominence of stock options is greater in newly public companies than in "steady state" public companies. The determination of equity award values and design is often done with consideration to several factors, including:

- The company's philosophy, objectives, culture and business strategy, which helps inform participation depth, equity vehicle form, vesting restrictions and/or performance criteria
- Competitive award levels by position/role
- Projected share use and expected duration of the equity incentive plan share reserve
- Market-acceptable levels of dilution and run rate
- Historical and targeted future company and individual performance

Monitoring share use and effectiveness of the equity compensation program over the life of the plan is critical to ensure equity compensation is being used prudently and in the best interest of shareholders. As the reserve is depleted, shareholder approval will be required to replenish the plan, unless the company's plan includes an evergreen provision.

Compensating the Board of Directors

The same process for pay benchmarking described above can be used to inform the board of directors' pay program. Companies should benchmark pay levels against a representative set of companies (often the same peer group used to inform executive compensation decisions). The process may differ somewhat for IPOs and SPACs, as IPOs may already have an established board and compensation structure that will be adapted to a public compensation structure. In a SPAC merger, the company may be assembling a board for the first time, or may have a board of directors with little or no compensation. Board of directors compensation becomes a critical factor early in the SPAC transaction process because they are actively recruiting independent board members while preparing to go public, and companies can have more effective conversations with candidates when a potential compensation program is in development. In some cases, in addition to the commonly offered pay elements of board retainer, committee chair and member compensation, and annual equity grants, we have found that SPAC companies may offer initial equity grants to directors, a potential key differentiating factor versus more mature companies.

Advice for Companies Going Public

There is a tremendous amount of work required to prepare an organization for life in the public markets. Companies must give themselves as much time as possible to move through each step intentionally and thoughtfully. A detailed project plan that outlines the required analyses, deliverables, responsible parties, events, key dates and decision deadlines, and project ownership goes a long way toward helping the company feel confident and prepared to undertake this intensive compensation decision process amidst all the other preparations required in a go-public transition. CS

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[1] *https://news.crunchbase.com/news/spac-vs-traditional-ipo-investors-see-benefits-of-blank-check-companies*


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