The Long and Winding Road:
The Course of Equity Awards on the Path to an IPO or Sale

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Objective: To provide a roadmap as to how privately held companies share equity with employees and other service providers, with an emphasis on pre-IPO/pre-sale technology companies.

Key Topics:

• Prevalence and Approach to Managing Equity Awards – page 3
• Typical Equity Pool Sizes and Grant Levels by Growth Stage – page 6
• Inflection Points in Grant Practices – page 14
• Standard Types of Awards – page 16
• Decreasing Award Values and Retention – page 18
• Closing the Sale/IPO – page 20
Starting Point: Prevalence of Stock Compensation – Growth Stage

• Founder-and “Angel” backed Start-Ups – not infrequently, allocation of ownership without vesting (vesting then reintroduced with further investment rounds); more informal understandings or individual agreements

• *Free-Standing Portfolio Companies – formal employee equity plans*

• *Venture-Backed Companies – formal employee equity plans*

• Joint Ventures – long-term incentives/agreements; frequently cash-based
• Subsidiaries – typically cash-based plans
• LLC/Partnerships – profit or capital interests
Starting Point: Prevalence of Stock Compensation – Industry

- Non-technology – typically top heavy participation

- *Technology – typically broad-based and stock compensation (mostly options for private companies). Is intended as a significant portion of the overall “pay mix”* [Why? Variety of reasons: (1) larger percentage/number of knowledge workers; (2) means of blunting unionization; (3) means of conserving cash, which is generally a scarcer resource; (4) at this point, because “everybody else does it”.]

- Manufacturing (non technology) – less typical (more use of ESOPs)
- Oil and Gas, Hospitality and Real Estate (REITS) – rare except for top heavy participation
Market Employee Ownership – Overhang and Annual Grant Rate

• A key goal is to manage dilution (and in effect, manage employee compensation).

• Analysts and investors typically evaluate a company’s ability to manage dilution by monitoring overhang as a company approaches an IPO and thereafter.

• “Overhang” is generally calculated as the sum of outstanding equity grants and shares available for grant divided by the total equivalent common stock outstanding.

• The chart below shows the aggregate stock compensation practices that are typical of technology companies over a period of time that approximates seven years, expressed in terms of annual and cumulative overhang percentages.

• Stock practices change at key intervals or key events in order to drive an appropriate level of overhang (we will address this item shortly).
Market Employee Ownership – Overhang and Annual Grant Rate

- A key goal is to manage dilution.
Example of Early-Stage Technology Company Stock Option Grant Guidelines

- The example below shows a company with 13.6 million shares outstanding, overhang of 27 percent and an annual grant rate of three percent.

<table>
<thead>
<tr>
<th>Job Category/Position</th>
<th>Participation</th>
<th>Range of New-Hire Options</th>
<th>Range of Follow-on Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executives – Tier I</td>
<td>100%</td>
<td>300,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Executives – Tier II</td>
<td>100%</td>
<td>160,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Management/Technical (Engineers)</td>
<td>95%</td>
<td>36,000</td>
<td>54,000</td>
</tr>
<tr>
<td>Professional Specialists</td>
<td>80%</td>
<td>19,200</td>
<td>28,800</td>
</tr>
<tr>
<td>Contributors</td>
<td>85%</td>
<td>4,800</td>
<td>720</td>
</tr>
</tbody>
</table>

- The underlying pay philosophy that drives employee grant guidelines will balance the company’s concern about diluting shareholder and founder/early employee holdings with the need to build the business.
Example of Early-Stage Technology Company Percentage of Stock Option Grants

• Early-stage technology company.
Example of Late-Stage Technology Company Stock Option Grant Guidelines

- The example below shows a company with 46.8 million shares outstanding, overhang of 16.6 percent and an annual grant rate of four percent.

<table>
<thead>
<tr>
<th>Job Category/Position</th>
<th>Participation</th>
<th>Range of New-Hire Options</th>
<th>Range of Follow-on Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executives – Tier I</td>
<td>100%</td>
<td>304,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Executives – Tier II</td>
<td>100%</td>
<td>152,000</td>
<td>72,000</td>
</tr>
<tr>
<td>Management/Technical (Engineers)</td>
<td>90%</td>
<td>40,000</td>
<td>14,400</td>
</tr>
<tr>
<td>Professional Specialists</td>
<td>85%</td>
<td>24,000</td>
<td>2,400</td>
</tr>
<tr>
<td>Contributors</td>
<td>50%</td>
<td>4,800</td>
<td>600</td>
</tr>
</tbody>
</table>

- Grant guidelines help the company minimize shareholder dilution, attract new hires and retain employees.
Example of Late-Stage Technology Company Percentage of Stock Option Grants

- Late-stage technology company.
Pre-Public Company Board of Directors Compensation

Board Affiliation and Compensation Prevalence by Role

- Independent Board members are compensated for Board service.
- Employee Board members or those members with significant company holdings are often not compensated for Board service.
- Compensation is almost exclusively in the form of stock options.
Impact of Stock Option Grant Guidelines vs. Market Data

• The key is to design a plan/process to minimize “dead equity” and maximize awards to key performers
• Example of an early-stage company:
Impact of Stock Option Grant Guidelines vs. Market Data

- Example of a late stage company
Employee Stock Grant Sizing *Always* Changes at Key Intervals

- Key intervals of growth or key events
- Acquisition/sale; major client; new senior management; overseas growth
- Transformation in the underlying value of shares – valuation methodology
- Risk/reward continuum challenged – changes to pay mix
- Growth stages
  - Start up – founder and angel rounds
  - High growth – venture-backed
  - Mezzanine – venture-backed and/or debt focused
  - Pre-IPO/sale – poised for liquidity

- Number of underlying shares (both individual grants and aggregate share of company allocated to employees) fall as strike (share) price/company market cap rises
Dilution Protection

• Very, very rare

• Hired CEO, founder(s), or early hire only

• For one round only – usually in process or being contemplated

• Typically defined/limited in an employment agreement (e.g., for a CEO being hired in the course of a financing)
Types of Grants

- Cost considerations of stock compensation (holding total number of shares issued constant)

<table>
<thead>
<tr>
<th>LEAST EXPENSIVE</th>
<th>MOST EXPENSIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stock Settled SARs</strong></td>
<td><strong>Restricted Stock</strong></td>
</tr>
<tr>
<td>Same expense (and value) of stock options but fewer shares are issued.</td>
<td>Highest impact on EPS due to higher per share expense.</td>
</tr>
</tbody>
</table>
| • Some design and communication issues (less familiar)  
  • Employee does not need to use cash to exercise | • High perceived value  
  • Easiest vehicle in which to introduce performance-based grants or vesting  
  • Use of share units can reduce ownership complexities in private companies  
  • Less flexibility to time occurrence of taxation |
| • Gap between expense and perceived value  
  • Longer vesting periods, shorter terms, greater forfeitures and delayed exercises reduce expense | |

- Rank the importance of shareholder dilution and expense impact with desired employee ownership and wealth creation
# Progress of Grants over Time

## Plan features

<table>
<thead>
<tr>
<th>Type of Grant</th>
<th>Typical Features</th>
<th>Description</th>
</tr>
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</table>
| **New-hire Grant (Initial)**  | Grant within first year of employment based upon internal grant guidelines and/or unique recruiting requirements  
Vests 20-25 percent per year | Consistent with competitive pay practices but allows for above-market grant for critical hires |
| **Milestone Performance Grant** | Grant to key executives or select employees  
Significant portion cliff vests upon achievement of pre-determined quantifiable milestone  
Will often vest in any event (e.g., six years) for smoother accounting treatment | Requires goal attainment before vesting  
Performance-based approach |
| **Follow-on (Refresher) Grant** | Grant every 12 to 48 months with vesting over three to five years (usually towards the longer end of this spectrum)  
Sometimes provided to supplement or in lieu of certain cash payments | Enhances retention and rewards performance  
Maintains market competitiveness |
| **Liquidity Performance Grant (sometimes)** | Grant at least one year before IPO/sale (liquidity/sale event) (key employees only)  
Significant portion cliff vests at date of IPO/sale  
Will vest in any event (e.g., six years) for preferential accounting treatment | Requires successful liquidity before vesting  
Performance-based approach |
A Bump in the Long and Winding Road – When Share Values Fall

- Dilutive round
  - Down round or significant increase in shares outstanding
- Repricing of options/SARs
- Sales proceeds “carve-out” plan
- New grants – additional shares
- Change the pay mix
  - Introduce new pay programs
A Bump in the Long and Winding Road – Retention

• Turnover
  ➢ Understanding the genesis – management, talent acquisition, job corruption/role creep, development, churn

• Compensate often with more than just equity
  ➢ Retention programs, sign-on bonuses and spot rewards
  ➢ Recognition and development

• Adjust or change type of equity awards

• Acquire small companies

• Diversify locations
The Long and Winding Road – Near Arrival to IPO

• A strategic path to change the total compensation mix
  
  ➢ Equity practices realigned; full-value awards more frequently evaluated and implemented
  ➢ Cash incentives tightened and aligned – notably sales commissions
  ➢ Benefit programs reviewed
  ➢ Administration, recordkeeping and compliance enhanced
  ➢ Shutdown of equity grants three to six months before and/or after IPO

• Pre-IPO compensation and benefit issues (see attached materials)
  
  ➢ Contemplation of the initial public offering
The Long and Winding Road – Near Arrival to Sale

• If employee equity values are projected to be significant, then often nothing is changed.

• If not, then one or more of the following steps are taken:

  ➢ Retention benefits to closing (or for a few months beyond closing) – typically a fixed award
  ➢ Acceleration of vesting six to nine months after liquidity event
  ➢ Success Bonus – variable award usually based on final sales price
  ➢ Shutdown of most equity grants between signing and closing (negotiated item)
Thank you for your attention.

Questions?
Biographies

David Broman

Mr. Broman is Principal and Chief Executive Officer of Syzygy Consulting Group. He has over twenty-five years of human resources management experience, both as a corporate executive and expert compensation and benefits consultant. His specialties include executive pay and equity compensation design for both public and privately-held companies. He has designed "pay-for-performance" base salary programs, short-term variable pay plans and long-term incentive compensation plans for companies in a variety of industries. Mr. Broman has also developed sales incentive plans to spur revenue growth and enhance profitability. With extensive international experience, he has a thorough knowledge of global remuneration schemes and has implemented compensation and benefits programs throughout Europe and Asia. Mr. Broman is a recognized expert in Board of Director compensation and effective executive compensation practices, with a unique understanding of cash and stock compensation practices at private technology companies. Finally, Mr. Broman has conducted strategic compensation planning sessions for Boards of Directors and executives, and focus group sessions that improve the link of pay-to-performance for a number of client companies.

Prior to joining Syzygy Consulting Group, Mr. Broman was Director of Corporate Human Resources for VeriFone Incorporated. He was previously Corporate Director of Compensation for Pacific Gas and Electric Company; Director of North America Human Resources for Thomas De La Rue Ltd., a British concern; Corporate Manager of Compensation and Benefits for Coca Cola Enterprises; and Manager of Corporate Compensation, Benefits and HRIS for Burlington Northern Air Express. Mr. Broman began his professional career at Ford Motor Company where he held various assignments in corporate compensation and benefits, employee involvement and total quality management.
Biographies

Brian Andriuzzo

Mr. Andriuzzo is Co-founder, Principal and Chief Financial Officer of Syzygy Consulting Group. He has over twenty years of specialized experience in human resources management and finance, both as a corporate executive and expert compensation consultant. His expertise includes design of executive compensation and equity programs for public and private technology companies, development of worldwide base pay programs, and market research and analysis. Mr. Andriuzzo has managed a variety of base pay delivery and variable compensation programs, including company-wide bonus and profit sharing plans, sales compensation plans, deferred compensation schemes and retirement income plans. With extensive experience in finance, he has a thorough knowledge of financial planning, analysis and modeling, instrumental to designing effective compensation plans.

Prior to forming Syzygy Consulting Group, Mr. Andriuzzo held senior management positions in compensation, benefits and HRIS at Ford Motor Company's USL Capital subsidiary and at 3Com Corporation. He began his professional career at Pacific Gas and Electric Company where he last held the position of Corporate Director of Compensation after various assignments in human resources management and organizational development. Mr. Andriuzzo held a number of multi-disciplined positions throughout his tenure at PG&E in engineering, corporate planning and finance. Before specializing in human resources at PG&E, he served as Assistant to the Vice Chairman of the Board and Chief Financial Officer.
Biographies -- Steve Fackler

Stephen W. Fackler is a partner in the firm's Palo Alto and New York offices and Co-Chair of Gibson Dunn's Executive Compensation and Employee Benefits Practice Group. Mr. Fackler has extensive experience nationwide advising public and private companies, private equity funds and boards of directors on compensation and benefits matters. He also regularly advises senior executives on their employment and severance arrangements and directors in connection with compensation and indemnification arrangements.

His practice focuses on:
- Designing and negotiating executive and director compensation arrangements
- Designing and implementing stock and other incentive plans
- Advising public company clients, their boards of directors and compensation committees on corporate governance issues and legal compliance involving a comprehensive range of compensation plans
- Advising companies, boards and management teams on compensation and benefits in mergers and acquisitions

Mr. Fackler serves as Chair of the Certification Council for the Certified Equity Professional Institute, the leading certification program in the United States for stock plan professionals. He also serves as outside counsel for the Global Equity Organization, the leading international trade association for stock plan professionals.

Mr. Fackler received his law degree from Stanford University in 1984. He earned an Honours B.A. from St. Johns' College, Oxford University in 1981. He completed his undergraduate education at Harvard University where he earned his Bachelor of Arts magna cum laude in History in 1979 and was elected to Phi Beta Kappa.

Mr. Fackler has been selected by Chambers and Partners as a Leading Employee Benefits Lawyer each year since 2006 (the first year in which the category was included) in its publication "America's Leading Business Lawyers" and as a Leading US Employee Benefits and Executive Compensation Lawyer by The Legal 500 in its inaugural 2007 and subsequent editions. Mr. Fackler was named among the Top 20 Most Powerful Lawyers for Employee Benefits and ERISA in Human Resource Executive magazine and Lawdragon in 2012. He is also recognized as a Northern California “Super Lawyer” and by Best Lawyers in America.