Principles of Executive Compensation

Chapter 3

Guiding Principle Case Studies – IPOs and Spin Offs

Initial public offerings: aligning compensation to reflect new owners' priorities

Scott Oberstaedt

As companies transition from privately owned to publicly traded companies, there is frequently a need to reconsider executive compensation (EC) policies so they align more closely with investors' expectations and public company practices. Four overarching EC principles form the foundation of an effective EC program, and because an initial public offering (IPO) by definition transfers ownership, the key overarching EC principles to consider are purpose and alignment. Specifically, the role of executive compensation in an IPO is to realign management's interests from the purpose of one set of owners to that of another, as expressed through the company's mission, strategy and objectives. Early efforts often focus on compliance and adherence to market norms, but an IPO also provides a unique opportunity to improve employee engagement and ensure that the executive pay program reinforces the company's long-term business strategy, and is not dictated exclusively by external interests. Similarly, in a spin-off scenario, the source of purpose and alignment will shift from the parent company to those of new investors, whether public or private. Shifts in ownership will also mean transitions in management accountability. This chapter illustrates these concepts with two recent IPOs: one owned by a consortium of private equity (PE) firms prior to the IPO (Trinseo) and, the other, a spin-off from a publicly traded parent company (Knowles).

Companies that are wholly owned by PE or venture capital (VC) firms may believe they are immune to the external forces that shape executive compensation today. With board of directors often made up entirely of investors and little to no public disclosure of executive pay plans, portfolio companies need only adhere to the rules and limits of their PE or VC owners in adopting and modifying compensation structures. Moreover, many investor firms use relatively standardized approaches to executive pay that emphasize value creation and offer the greatest rewards when the internal rate of return to investors exceeds a predefined threshold.

However, all good (or bad) things must come to an end, and for PE- or VC-owned portfolio companies, the "end" often is in the form of an IPO. An IPO may be celebrated as an opportunity to "cash in" on hard work and high performance, but for U.S. companies it also lays bare many of the decisions made pre-IPO about executive pay, including CEO pay levels and employee equity grants. It also signals a time to shift from private-company to public-company practice where the needs of a larger and more diverse set of stakeholders can play a role in future compensation plan design.

The IPO process

Companies contemplating an IPO tend to fall into one of three categories:

- *Founder-backed* or *VC-backed IPOs* are typically companies entering the public market for the first time.
- *PE-backed IPOs* often, but not always, were public companies prior to being purchased by private equity.
- *Corporate spin-off IPOs* create a new public company out of a division or subsidiary of another larger company.

These different backgrounds can have a distinct effect on the extent to which each company already has adopted policies that align well with the EC principles. For example, many VC-backed IPOs have very limited governance policies in effect prior to the IPO, but their above-average use of equity-based compensation plans creates a high degree of alignment between executives and owners around purpose and other key company features. The most common difference between a typical pre-IPO company and a public company is the high degree of reliance on a very small number of financial goals to determine compensation — so much employee value is tied to the investors' rate of return upon the IPO that nonfinancial performance is considered irrelevant. Spin-offs are most likely to have plans and policies that follow the EC principles of the parent company.

Importantly, the change in ownership in these scenarios — from VC investors to public shareholders, for example — will most likely mean shifts in the stated purpose and strategy of the company. A newly public company may, for example, become more growth-oriented because through the IPO process it has raised significantly more capital to deploy. Alternatively, a business that has gone through a dramatic restructuring under PE ownership may require a steadier, conservative approach to value creation post-IPO, to serve the interests of the new set of shareholders. It's critical to create alignment between owners and managers around these shifting strategies. The newly public company will also have more varied compensation vehicles at its disposal, with more access to ongoing rewards for performance across short- and long-time horizons through the use of public market stock.

In this context, companies contemplating an IPO most frequently ask two questions about the EC principles:

- How compliant is a newly public company expected to be?
- How much time should it typically take to align with best practices?

We consider both of these questions in the two following examples, Trinseo S.A. and Knowles, as guided by the overarching EC principles at play here: purpose and alignment.

I. Trinseo S.A.: Going public may require PE companies to develop new compensation processes

Since its purchase by Bain Capital in 2010,[1] industrial materials manufacturer Trinseo knew that its time as a portfolio company would be limited. The average holding period for a PE-owned portfolio company is six years,[2] so either an IPO or a follow-on sale to another company seemed inevitable; the only questions were which path Bain would pursue, and when. A June 2011 SEC filing for Trinseo (then known as Styron) was withdrawn without being executed in June 2013,[3] but the company refiled for an IPO in March 2014.[4]

The initial S-1 filed by Trinseo[5] showed an EC structure that reflected the purpose and business objectives of its owners. Annual incentive plans had heavy emphasis on EBITDA and fixed-cost management as performance goals. Long-term incentive plans (LTIP) included time-vested and performance-based equity grants that were not made annually, but only when a new employment agreement was signed; this often led to substantial year-over-year changes in reportable compensation. Long-term plans also concluded with cash payments, not equity grants. Executive benefits were generally limited to pension plans, life insurance and service awards. In addition, there was no discussion of a Trinseo executive pay philosophy, peer group, benchmarking process or target pay mix to promote alignment with company strategy and objectives.

From the onset, Bain Capital recognized that its pre-IPO EC approach worked while Trinseo was a portfolio company, but the policies and processes did not reflect those of a traditional public chemical company. As such, along with Trinseo's management team, Bain Capital championed the effort to create a framework that would be most acceptable to the new public shareholders and other outside interests.

The first step in this process was the establishment of a 22-company peer group and compensation benchmarking process that could be used as an input in future EC decisions. The peer group was approved pre-IPO by the compensation committee at the time, and carried over to become the peer group that Trinseo's post-IPO committee also used for executive pay reviews. The compensation benchmarking process used data from both the peer group's most recent annual proxy statements and Willis Towers Watson survey data, custom cut to reflect the materials manufacturing business in which Trinseo operates.

The market analyses conducted with these sources covered both executive target pay levels and certain compensation design features, such as annual and LTIP details. As part of this incentive plan review, the committee determined that a mix of options and full-value shares would be a preferred

---

[1] http://www.trinseo.com/company/history/
[2] http://www.cepr.net/blogs/cepr-blog/plain-talk-about-private-equity
[3] http://www.reuters.com/article/2013/06/14/trinseo-ipowithdrawal-idUSL3N0EQ3CV20130614
[4] http://www.reuters.com/article/2014/03/14/us-trinseo-ipo-idUSBREA2D1L920140314
[5] http://www.sec.gov/Archives/edgar/data/1519061/000119312514203001/d681018ds1a.htm

post-IPO grant strategy, and the Trinseo omnibus award plan adopted immediately prior to the IPO was broadly written to allow for discretion in the form of equity used. Options made up the majority of the equity value granted to Trinseo top executives in the first LTI grant cycle following the IPO.[6]

Trinseo also conducted a review of several executive policies immediately following its IPO. After reviewing market practices, it adopted a new nonemployee director compensation policy, executive severance and change-in-control plans.

Trinseo and the operating principles

Trinseo's PE owners did not revisit compensation policies and processes because of concerns about the initial shareholder say-on-pay vote — passage of the nonbinding referendum was effectively guaranteed because the PE owner retained a majority share interest in Trinseo after the IPO was completed. Instead, it was driven by a desire to establish a process that would be consistent with other public company practices and could be retained by the compensation committee once Trinseo was no longer a controlled company. The overarching principles of purpose and alignment were supported by adherence to several operating principles, as discussed below. These operating principles provide specific, practical guidance for interrelated EC areas outlined in each section.

Section I: Governing objective and EC philosophy

Operating principle #6: Organizations should articulate their reward strategies.

The public statement of a reward strategy is a new issue for many companies that undertake an IPO — it's not that a reward strategy did not previously exist, but that (a) it reflected the interests of a different, private ownership structure, and (b) often it was more inferred than formally articulated. The first post-IPO Compensation Discussion and Analysis explained fully the underlying purpose of Trinseo's various reward programs, and how the company incorporated external market data and business strategy into its decision-making process.

Section II: Pay level reference group selection and benchmarking

Operating principle #1: Benchmarking analyses should be based on the most robust and credible data available and avoid an overreliance on a single data source.

Trinseo's selection of a peer group consisting of 22 publicly traded companies was an important step in formalizing its EC benchmarking process, but this information was insufficient to benchmark all executive officer roles. Therefore, the committee also reviewed independent survey data to help

[6] http://www.sec.gov/Archives/edgar/data/1519061/000119312515078844/d887385d8k.htm

determine the pre-IPO pay positioning for each executive officer and to make holistic, informed decisions about post-IPO compensation packages for Trinseo's leaders.

Operating Principle #5: When selecting a primary market reference group for compensation benchmarking, an organization must provide a rationale for the inclusion of organizations with significantly different revenue sizes.

Trinseo selected a 22-company peer group that had a relatively wide range of enterprise values, ranging from $700 million to $7 billion. This wide range of company sizes was seen as necessary to capture fully two of the most critical screens used by the committee to build a peer group: the most direct competitors for Trinseo's products and the most likely competitors for Trinseo's key talent. The wide range of enterprise values also allowed Trinseo to consider companies with a similar debt-to-equity structure, which for recent IPO companies can be markedly different than for companies that have been public for a longer time.

Section III: Performance-based pay

Operating principle 3: The incentive plan design should reflect the organization's desired balance of shareholder alignment and line-of-sight-related objectives through the selection of LTI vehicles, and the weighting and selection of incentive measures.

After the IPO, no single element of Trinseo's executive compensation changed as much as its LTIP. Trinseo's initial post-IPO LTI grants consisted of a mix of full-value restricted share units and time-vested stock options, which differed from its previous reliance on executive subscription agreements that offered full-value shares to executives in exchange for voluntary coinvestments. Consistent with the practices of many recently minted IPOs, Trinseo determined that setting multiyear goals for a traditional performance plan was not appropriate at this first stage of the company's lifecycle, and that the company would reconsider in future years.

Section IV: Governance

Operating principle 1: The committee must be directly accountable for making decisions about the compensation of the CEO and the senior executive team, and for monitoring the implementation of EC programs.

The formalization of the Trinseo compensation committee charter was a critical part of the pre-IPO governance process. Even though Trinseo remained a "controlled company" with a majority of its voting rights retained by Bain Capital after the IPO, the charter was designed to establish a process of responsibilities that could continue after Bain Capital had divested its majority interest. The four major post-IPO responsibilities, included the following:

- A review of key EC goals, policies, plans and programs
- A review of the compensation of Trinseo's executive officers

- A review and approval of employment agreements, and other similar arrangements between Trinseo and its executive officers

- Administration of the equity-based plans and other incentive compensation plans

These responsibilities also include an annual assessment of the CEO's performance and pay, as well as the final approval of any compensation payments to all Trinseo executive officers.

Operating principle 11: Consistent with local market standards and requirements, committees at public companies should ensure that the public disclosure of the total compensation philosophy and pay design for all members of the senior executive team and their rationale is presented concisely — and comprehensively — in plain language without the use of legalese.

Despite its status as a controlled company, Trinseo's public disclosures on executive pay have been thorough since its pre-IPO S-1 statement. It has highlighted the link between business achievements and executive compensation, and has used the annual proxy statement to clearly delineate where certain compensation plans are legacy plans in place prior to the IPO, and where new plans have been approved and implemented. With that said, some popular disclosure elements commonly included in the proxies of more established public companies, such as realizable pay or pay-for-performance comparisons, were not initially included in Trinseo's disclosures. As the company builds a multiple-year history of both financial performance and post-IPO compensation plans, some of these newer disclosure elements may be added, ensuring that the EC plan and practices stand up to public scrutiny as needed.

Section V: Other terms and conditions

Operating principle 2: If organizations provide equity compensation, they must adopt share ownership guidelines and should scale them to reflect the value of the equity compensation levels.

It is interesting to note that Trinseo did not adopt share ownership guidelines as part of its IPO process. However, the company noted in its 2015 proxy statement that all named executive officers had retained the shares received as part of the pre-IPO executive subscription agreements, and that alignment with owners was a critical element of the LTIP design. In 2015, Trinseo developed and adopted a robust policy of stock ownership guidelines and retention requirements, reinforcing alignment with shareholders. It is common for companies going through an IPO to prioritize development and implementation of certain elements of the executive pay program, and to leave other tier-2 items — which often include stock option grants and other non-core features — for the year of, or the year following, the IPO.

II. Knowles: Spin-offs have their own compensation considerations

Dover Corporation announced in May 2013 that it would divest its primary acoustics business, Knowles Electronics, into a fully independent, publicly traded company via a tax-free spinoff. Founded in 1946, Knowles had never been an independent public company, and the spin-off would result in significant changes in executive leadership, structure and reward plans. Knowles had to adapt its EC programs to reflect its purpose and strategy as an independent, publicly held organization.

The compensation decisions made during a spin-off IPO are inherently different from those at other IPOs in three critical ways. First, the company to be spun off often does not have all internal staff established early in the process (such as compensation and benefits employees), and must rely on the parent company staff to manage the early stages of the spin-off process. Second, the parent company tends to use its own compensation principles and policies as a starting guideline for the spin-off's compensation plans, preferring continuity in compensation philosophy and structure (commonly referred to as a "lift and shift" approach) — which may or may not correspond well to the needs of the new owners. Third, the parent company board of directors and/or compensation committee have responsibility for approving all major EC-related decisions for the spin company prior to the spin-off, even though they will have limited to no authority immediately following the spin-off. These issues lead to unique dynamics in the development of new plans and, if not managed effectively, those dynamics can lead to conflicts between the parent company and the spin company about the appropriate post-spin compensation plans.

Dover's shared services team actively managed the earliest steps of the process to build a post-IPO EC plan for Knowles, while Knowles actively recruited for select human resources and other shared services employees who could assume the responsibility of managing the spin-off process. This was nearly a year-long process where Knowles's post-spin executive officers needed to be identified and/or hired, new peer groups and pay strategies created, incentive plans transferred from Dover to Knowles, and governance rules built that would apply to Knowles executives post-spin.

These decisions about how Dover plans would transfer to Knowles, were communicated to shareholders prior to the spin-off using the Knowles' Form 10 disclosure[1] to explain how the "going forward" EC strategy would compare to Dover's strategy. For example, a Dover cash LTIP that applied to select Knowles executives prior to the spin-off would be discontinued, and Knowles' long-term compensation would focus on a mix of stock options and full-value share awards. Knowles also elected not to adopt a defined benefit pension plan or a pension replacement plan, both of which were offered by Dover. These decisions for Knowles were made by Dover's compensation committee to reinforce Knowles' strategic goals of shareholder value creation and executive alignment with the company's owners.

[1] http://www.sec.gov/Archives/edgar/data/1587523/000119312514038851/d602430dex991.htm#toc602430

Prior to the IPO, Knowles also adopted several “good governance” policies that mirrored those of Dover. A clawback policy, anti-hedging policy and share ownership guidelines were put in place prior to the spin-off to show a continued commitment to appropriate risk management and governance principles. Individual executive employment agreements were also eschewed. Instead Knowles provided an all-executive severance and “double trigger” change-in-control severance policy that provided a uniform level of protection in the case of a termination.

When the spin-off was completed in February 2014, Knowles immediately prepared for its initial shareholders’ meeting in May of that year, when its new shareholders would vote for the first time on Knowles’ executive officer compensation plans (“say on pay”). The continued disclosures about the new plans and policies throughout the IPO process in the Form 10 and the subsequent 2014 proxy statement were eventually well-received by shareholders, with 98% approval in the first year.

Knowles and the operating principles

As a spin-off IPO company, Knowles gained an advantage from the guidance and recommendations of its former parent company, Dover, when it came to adopting sound operating principles that would align management around the new company’s purpose. The establishment of Knowles’ EC strategy was a collaborative process — including Knowles executives, Dover HR leaders and the Dover compensation committee — so that the strategy could be assumed by Knowles’ board following the spin-off without requiring significant adjustments. The EC disclosures prior to the spin-off also went far beyond basic compliance, helping the reader to understand not just what had been paid but also what was expected to be in place in the future, speaking to the greater transparency required around compensation for a public company.

Section I: Governing objective and EC philosophy

Operating principle #3: Each organization’s business and people strategies should align with long-term value creation, and should drive the design and management of the organization’s compensation programs.

Knowles’ post-IPO compensation strategy did not exclusively rely on Dover’s compensation strategy because it was the administratively easiest approach to complete the spin-off. Every major element of the legacy Dover compensation program was considered and measured against the independent Knowles business strategy, and while some plans were continued, others were modified significantly to reflect the new business’s purpose and goals and align management with these.

Section II: Performance-based pay

Operating principle #3: The incentive plan design should reflect the organization’s desired balance of shareholder alignment and line-of-sight-related objectives through the selection of LTI vehicles, and the weighting and selection of incentive measures.

The post-IPO incentive plans for Knowles’ executives included a significant shift in risk and leverage, and provided a more externally-focused approach. The company’s incentive goals included top-line (revenue), bottom-line (EBIT), operational, leadership and share value-related objectives, and no one performance measure was used in both annual and LTI compensation.

Section III: Governance

Operating principle #2: The committee must ensure that there is an appropriate Total Rewards philosophy for executives and consider the need for its alignment with the broader reward strategy of the organization as a whole.

The Knowles executive reward philosophy in place at the time of the IPO was approved by Dover's committee, not by Knowles' compensation committee. However, Dover approved Knowles' plans after a review process that considered the business strategy of Knowles independent from Dover, and throughout the IPO process Dover management disclosed how the new Knowles reward philosophy would vary from Dover's plans. In addition, future Knowles compensation committee members were identified prior to the IPO and included on an advisory basis in the Dover committee's deliberation process.

Pitfalls of designing incentive systems for IPOs

Here are several important pitfalls to avoid when designing EC systems as we have seen from recent IPO companies:

- Don't let outside interests determine the results. There is often a heightened interest among new board members about the say-on-pay vote and the role that proxy advisors play in that vote. While those companies should be monitored, they should not drive the process. A well-designed, well-communicated EC plan should take precedence over maximizing a corporate governance score.
- Don't be afraid to adapt. While plans may be put in place with the best intentions at the time of an IPO, it is also a time when a company is first learning about its new prospective shareholders and their expectations on creating long-term value and growth. Compensation committees should maintain the flexibility to modify their courses of action — whether it be in peer group selection, target pay positioning, pay mix or plan designs — to reinforce those shareholder goals.
- Don't exchange long-term thinking for short-term fixes. While it is important to be flexible, it is counterproductive to divert course too frequently. Recent IPO companies often see the most significant swings in market value of any publicly traded companies, and while it is tempting to change goals or the LTI mix in response to market forces, overreactions can lead to unintended consequences. Sometimes it is better to maintain an overall compensation structure through the post-IPO period and revisit the company's market value only when it is more firmly established.

Key takeaways

Important takeaways related to designing EC systems as evidenced from recent IPO companies include:

- *The right processes and protocols are as important as having the right policies.* A newly public company needs to establish its compensation committee charter, calendar and cadence in a way that will support a thorough and transparent decision-making process when it comes to executive pay.

- *The best designs may take time.* Without an established track record as an independent public company, compensation design features that are common in other companies, such as performance share plans, may be more difficult to adopt in a way that creates sufficient alignment between performance and rewards in line with the new owners' purpose.

- *A little disclosure goes a long way*. Careful communication of the newly public company's EC system and components can help preempt any concerns on the part of new shareholders and the broader public.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has over 40,000 employees serving more than 140 countries. We design and deliver solutions that manage risk, optimize benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com

Willis Towers Watson