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PDA Newsletter April 2016

Executive Compensation in Private Firms

A Principled Approach for Owners and Private Company Boards

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The Role of the Board in Building and/or Rebuilding the Business

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Executive compensation in privately owned firms is very different from incentive systems in their public counterparts. In fact, applying typical public firm compensation approaches and practices to privately held firms can result in costly, long-lasting problems. The most basic differences between the two types of businesses include the lack of publicly traded stock as a compensation vehicle and the absence of public shareholders as stakeholders in private firms.

While the components of executive compensation systems may differ between public and private firms, the principles with which these systems may be approached are the same. The next section lays out the four interrelated, overarching principles that any executive compensation system strategy or design should reflect, and how they apply specifically to private companies. After that I present 10 critical questions to address for private company compensation systems, based in part on the principles.

Four Overarching Principles for Executive Compensation

The four overarching principles for executive compensation are purpose, alignment, accountability, and engagement. These principles are key to effective private company compensation, as described below:

Purpose

If the primary objective of an executive compensation system is to align the interests of a corporation's owners and its managers, it's critical to understand the private company owners' purpose for the organization. Why do the owners hold the company in the first place? What do they see as its raison d'être? What do they hope to get out of the company in the short and long term, from financial and personal standpoints? Thus the development of an optimal compensation system requires full understanding of owners' financial and non-financial objectives, as embodied by their sense of the firm's purpose. That includes what they see as the mission of the company in the broader business community and society as a whole, along with an understanding of their time horizon and possible endgame.

Alignment

As implied by the elements of purpose discussed above, annual and long-term incentives in private firms must be aligned with the clearly defined short- and long-term interests of the owners. For example, there will almost always be inherent tradeoffs between generating cash flow and dividends and reinvesting capital for long-term value creation. There are also predictable tradeoffs between steady, more reliable performance and higher-potential but riskier growth. An effective incentive plan will be designed to align managers with owners' preferences on all these dimensions, along with their relative risk tolerance.

Accountability

Compensation programs are often the key driver of accountability within a business—not only between management and the board, but throughout the entire organization. As such, the selection and definition of performance measures and ranges, goal-setting, exception policies, performance evaluation practices, and determination of incentive payouts must be carefully devised to send strong messages firm-wide about what is expected of all employees—and how they will be rewarded for meeting the standards set.

Engagement

Compensation programs are core means of engaging executives and other employees: motivating them, driving ongoing performance, and sharpening focus on shared goals. That means incentives should be structured such that they are understandable, based on objectives that are simultaneously challenging and achievable, and enable managers to feel they have control over the elements by which their performance will be evaluated. Compensation systems, overall, must also be competitive with those provided by peer firms. This is particularly challenging for private companies, which lack the ability to provide incentives with publicly traded stock. In line with this, market data suggest that private companies tend to pay salaries and annual incentives that are competitive with public firms, while their longer-term incentives tend to have lower target values (but also tend to pay out more consistently over time).

10 Compensation Questions Private Firms Must Address

The questions below are critical for private firms to address when thinking about their executive compensation systems.

1. What is the firm's specific purpose and mission?
2. What do the owners hope to achieve—from a financial and non-financial standpoint—in both the short and long term?
3. What are the tradeoffs between cash flow/dividends and long-term value creation?
4. What is the desired overall risk level for the business?
5. What are the key measures of short- and long-term success?
6. Does the company prefer to use real or phantom equity as part of compensation packages?
7. How does firm value itself, how frequently does it undertake valuation, and by what means?
8. How will real or phantom stock be monetized (cashed out) over time?
9. To whom does the company compare itself for purposes of compensation as well as performance?
10. How difficult has it been for the firm to attract and retain key executive talent and what factors contribute to this?

Privately owned companies including family businesses tend to have highly customized executive compensation programs designed to fit them across key dimensions: mission, purpose, strategy, risk orientation, time horizon, end game, and others. Rather than trying to mimic public company practices, private firms will benefit from relying on the set of guiding principles presented here and their own unique answers to the questions outlined above.

Don Delves is a Director in the Executive Compensation Line of Business and specializes in advising family and closely held businesses. Based in Chicago, Don is a leading expert and highly sought-after consultant and speaker on corporate governance and executive pay and performance. Don leads Willis Towers Watson's Closely Held Business Practice and is a recognized expert on principles-based corporate governance, incentive design, performance measurement and value creation. Delves holds a doctorate in education in principles-based corporate governance from Fielding Graduate University, an M.B.A. degree in finance from the University of Chicago and a B.A., summa cum laude, in economics from DePauw University.