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The Allure of Private Equity and its Impact on Performance Pay in Publicly-Held Companies

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Despite anecdotal evidence to the contrary, private equity packages may not help public sector companies win the war for talent.

In this post-Enron, post-Sarbanes-Oxley era, the complexities and vulnerabilities involved in running public companies have greatly increased, and the perks for being the CEO of a public company have been greatly diminished. At the same time, the critical executive talent needed to drive outstanding corporate performance has become a dwindling resource in an expanding marketplace.

*“Private equity owners really pay for performance...and the CEOs won't be criticized for making a lot of money...because private equity investors are clearly at arms length.”*¹

*Steven N. Kaplan, University of Chicago
Graduate School of Business*

While there is no data to show that the allure of private equity deals has increased CEO resignations from publicly held companies, some corporate search firms have said that private equity deals have had a major impact on CEO turnover in publicly-held companies.² For companies that remain publicly-held, private equity deals have become a major alternative that threatens to drain the available pool of critical executive talent (See Table at the end of this article).

¹ David Wessel, “Closing the Door: Going Private Offers Rewards,” *Wall Street Journal* May 17, 2007.

² See presentation by Robert Hallagan, Vice Chairman, Korn/Ferry International, at The Conference Board's Executive Compensation Conference in October, 2007.

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What Is the Attraction?

CEOs and other top executives of publicly held companies find private equity deals appealing for a number of reasons.

Private equity executive pay structures typically align the interests of managers with those of the sponsors, who are the antithesis of risk-averse, since their own money is at stake. Private equity sponsors are said to have a great incentive to be tough in paying the CEOs they appoint only for results.

The private equity pay-for-results model is really quite simple: managers who succeed in generating the necessary cash flow to retire debt and otherwise get their company ready to be sold in a sufficiently short period of time, and at a sufficiently high price to earn the sponsors more than their cost of capital, will accumulate major personal wealth over that same relatively short time frame.

*“The major thing that’s wrong with large public corporations in the United States: the CEO has no boss...Private equity fixes that very well. The CEO has a boss.”*³

Michael C. Jensen, Harvard Business School

By contrast, CEOs of publicly held companies are accountable to public company boards, who have been placed under increased scrutiny due to newly expanded public disclosure regulations. The result has been a risk adverse, short-term culture in the boardrooms of many publicly-held companies that makes it difficult for CEOs to streamline and improve operations substantially or adopt a dramatically different strategic focus. In order to deliver the steady shareholder returns their boards favor, many public company CEOs resort to practices such as share purchases, divestitures, layoffs and offshoring.

From a compensation stand-point, current boardroom culture helps explain one of the biggest differences between executive pay in private equity deals and executive pay at publicly held companies: rather than make front-loaded or one-time equity pay arrangements, as private equity companies typically do, public companies typically make annual long-term incentive grants. Unlike private equity companies, which denominate their equity pay arrangements in terms of specified individual percentage equity

stakes, most public companies use Black-Scholes or some other, similar valuation methodology to make equity pay arrangements that have estimated dollar compensation values.⁴

This allows public companies to plug in equity pay that has the estimated value necessary to give an individual executive’s overall compensation package the size and pay mix deemed necessary to make the company competitive in the battle for top talent.

The most critical difference lies in most public companies’ practice of pegging long-term incentive grants to estimated dollar values, instead of granting specified individual equity stakes; in other words, most public companies grant more shares when the share price has dropped, and fewer shares when it has risen. In an era when all equity grants will be quite transparent, shareholders will understandably have problems making sense of this practice. Yet given the finite pool of top corporate talent, it is easy to understand why public company boards would want to assure that their CEOs receive competitive pay packages year in and year out.

Performance Pay Is Not a Panacea

Demands that public company boards revisit and revise their executive compensation programs to emulate private equity-like pay-for-results programs are simplistic. Revising executive pay is not enough to achieve private equity like results.

It is one thing to commit to paying for results, but quite another to be bold when it comes to ensuring that the necessary critical top talent is recruited and retained for the long-term. This means having the right CEO for the right situation, and the right personnel for all other critical positions. But most importantly, management teams at any publicly-held company must share more than a profitable exit strategy. They have to believe in each other, in their business strategy, and their prospects for continued success. But how can a publicly-held company keep its critical executive talent motivated and from jumping to private equity deals?

³ Louis Uchitelle, “Revising a Boardroom Legacy,” *The New York Times*, September 28, 2007. Jensen was an early advocate of large pay-for-performance compensation packages for CEOs.

⁴ Recently, companies such as Zion Bancshares and Google have begun experimenting with market-based valuation methodologies.

The Case of Public vs. Private

One possible solution to the dilemma of executive motivation may be changing the company's long-term incentive compensation portfolio, typically the most significant part of the overall rewards package for senior executives, to more closely resemble the pay-for-results programs in private equity deals.

If public companies chose to make up front awards with deferred vesting to protect against resignations or terminations for poor performance, they would gain the advantage (or disadvantage) of passing the risk of subsequent increases or decreases in share price on to award recipients.

Public companies may also need to reconsider how they denominate equity awards. Private equity firms deal in risk/reward-sharing concepts like “carried interests” and “buy-ins,” which are denominated in specified numbers of shares. In making their annual long-term incentive awards, public companies typically grant more shares when the share price drops and fewer shares when the share price rises. But some public companies might actually be able to make larger awards to their key executives by granting specified individual equity stakes up front that can increase or decrease in value with subsequent stock performance, particularly in situations where management's past performance has already resulted in stock price appreciation.

Another difference between long-term incentives in private equity deals and long-term incentives in publicly held companies is that the former rely heavily on stock options, which have lately been falling from favor among publicly held companies.⁵

5 From 2004 to 2006, the median number of total stock options granted annually by Fortune 1000 companies fell at an annual rate of 23.2 percent, reaching a median of 881,000 shares in 2006. Likewise, the prevalence of Fortune 1000 firms reporting the use of options fell from 87.8 percent to 78.6 percent over the same three-year period. Not surprisingly, as the number and prevalence of stock option grants at Fortune 1000 companies declined, so too did the median number of options outstanding at the end of each fiscal year. From 2004 to 2006, the median number of options outstanding declined at an annual rate of 13.6 percent. Source: Equilar, Inc. www.equilar.com

While most public companies use a combination of equity compensation vehicles,⁶ whole share awards—such as restricted stock that is awarded or that vests based on performance—have come into favor with many public companies.⁷ Private equity firms typically use restricted shares only for incumbents' “buy-ins.”

Whether a public company should emulate private equity firms in relying principally on stock options would depend upon its growth goals. It would further hinge on the board resolving issues relating to its belief, and the beliefs of its executives, in the potential prospects for stock price appreciation as well as their concerns over stock price volatility. Other issues coming into play would be the availability of shares under shareholder-approved stock incentive plans and shareholder dilution concerns that might affect their authorization of additional shares under these plans.

Another key issue for public companies seeking to emulate pay-for-results programs similar to those in private equity companies is the selection of the right performance metrics on the basis of which the upfront equity awards will vest. Highly uncertain business conditions can make this a bit tricky. But it is crucial to link long-term incentive compensation value to the creation of shareholder value.

6 The following chart illustrates the prevalence of various equity compensation strategies at Fortune 1000 companies over the last three years:

Fiscal Year	Prevalence of Companies Granting Options Only	Prevalence of Companies Granting Restricted Stock Only	Prevalence of Companies Granting Both Equity Types
2004	45.2%	4.0%	42.6%
2005	38.6%	7.8%	45.3%
2006	27.7%	10.9%	50.9%

Source: Equilar, Inc. www.equilar.com

7 From 2004 to 2006, the median number of restricted shares granted each year by Fortune 1000 companies increased at an annual rate of 16.2 percent, reaching a median of approximately 312,000 shares in 2006. Furthermore, the prevalence of companies reporting restricted stock grants to employees increased from 46.6 percent in 2004 to 61.8 percent in 2006. The median number or restricted shares outstanding each year at Fortune 1000 companies increased from approximately 493,000 in 2004 to nearly 729,000 in 2006. In 2006, 43.6 percent of Fortune 1000 CEOs received a grant of performance-based equity, with the most common form being long-term incentive plan grants denominated in stock. By way of comparison, 61.3 percent of S&P 500 CEOs received shares with performance-based vesting criteria.

Source: Equilar, Inc. www.equilar.com

Public companies are often inclined to use stock price as a performance metric to achieve alignment with shareholder interests and ensure that the timing of large award payouts will not offend shareholders.⁸ But stock price performance metrics, even relative stock price performance metrics, are based upon market reactions to companies' performance and are subject to various market distractions at any point in time. These items may distract from the linkage to the creation of shareholder value.

How Do We Get There—and Do We Want to Go?

In order to truly emulate pay-for-results programs, public company long-term incentive awards should logically use cash flow return on investment (CFROI) as the key performance metric. Not only does CFROI matter most over time in determining market stock price. It also corresponds nicely with private equity firms' need to generate cash to retire debt and earn more than their cost of capital for their investors.

A public company wanting to change its long-term incentive compensation portfolio to match pay-for-results programs should consider

- making one-time equity awards with multi-year vesting periods, rather than annual grants,
- taking an “equity stake” approach in denominating these awards,
- switching back to stock options instead of full value share awards, and
- using CFROI as the performance metric for leveraging equity-based awards.

Can all public companies do this if they want to?

The answer is yes—but for a variety of reasons, most public companies are more likely to attract, motivate, and retain critical executive talent with a well-designed, but more traditional pay package than by private-equity-like pay packages. Probably, only a select number of public companies may wish to make the necessary changes to their current long-term incentive compensation program.

Any public company willing to do so would need an experienced and respected management team motivated to make substantial bets on itself. It would also require supportive, sophisticated shareholders willing to authorize the necessary dilution levels resulting from upfront equity awards. The publicly-held companies most likely to fit this profile are likely to be companies in turnaround situations or companies with unlocked value, i.e., the very companies private equity firms and hedge funds might be interested in.

Most boards and management teams at public companies are no more willing to take disproportionate risks by adopting a private equity management pay structure than their top executive would be likely to jump to a private equity deal. Nor can most public companies be assured of the requisite shareholder support for an immediate increase in dilution levels. The reason for this hesitancy is that most public companies are not failing to unlock value or, if they have been failing to do so, have not yet discovered the key business strategy that will remedy the situation.

⁸ FAS 123R has recently made this somewhat risky in that estimated expense charges cannot be reversed in subsequent periods if the performance goals upon achievement of which the estimated charges were promised involve stock price appreciation.

Table 1:

Factors influencing executive pay packages in private equity deals and publicly held companies

Factors at play	For private equity portfolio companies	For publicly-held companies
Denomination of, and limitations on equity pay arrangements.	Equity allotments denominated in terms of specified individual percentage equity stakes; equity pools capped at a specified percentage of total equity to control economic dilution of sponsors' investment.	Equity pay arrangements denominated in estimated dollar compensation values based on Black-Scholes or other valuation methodology to control compensation expense.
Impact of FAS 123R mandatory option expensing.	Financials not published; stock options typically extended to wide group of key employees.	Employee eligibility for stock option grants typically restricted to reduce reported compensation expense.
Time horizons of equity pay arrangements.	Front-loaded or one-time equity allotments with vesting based on continued employment; results achieved in the deal can double the vested amount. Managers not permitted to cash out equity until a liquidity event occurs (e.g., IPO, sale, divestiture).	Annual long-term incentive compensation grants, typically with time-based or performance-based vesting or both. Managers permitted to cash out equity after vesting, subject to applicable executive equity retention or holding requirements.
Risk profile of equity pay arrangements.	Rely principally upon stock option grants for long-term incentive compensation; typically require mandatory rollover of a portion (e.g., 50 percent) of incumbents' existing equity holdings into restricted stock when company is taken private. Managers assume all stock performance risk, as equity stakes are fixed as equity percentages, increasing or decreasing in value with changes in stock price.	Combination of equity compensation vehicles, including both options and whole share awards, (e. g. restricted stock, performance shares). Matching competitive estimated compensation values of annual awards results in “dollar averaging”—granting more shares when share prices drop and fewer shares when share prices rise, affording executives some protection against stock performance risk.