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# IPOs: An Important Long-Term Approach

By Chuck Yen

**Life as a public company is not without its challenges — in particular, the regulatory requirements in connection with executive compensation can be significant and are best dealt with early in the process.**

Initial public offerings remain an essential long-term strategy for many companies to fuel business growth, provide liquidity to investors and create powerful employee incentives. In 2011, the stock market managed to squeeze out more than 100 IPOs and, though these numbers trail the boom years of the late 1990s, the question is not *if* but *when* the IPO market will rebound.

The allure and prestige of being a public company is ingrained in the DNA of corporate America. And until lending eases and investments pick up, company executives will continue to view an IPO as a potential source of capital. Moreover, there is evidence to suggest that an IPO could actually prove beneficial to a sales transaction.

According to a recent study conducted by professors at Brigham Young University and the University of South Florida, companies that pursue a dual-track strategy (i.e., an IPO along with putting themselves "on the block") could fetch a higher sales price — as much as 26 percent higher — that is partly due to the transparency of information and number of potential investors.

## Regulatory Considerations

Life as a public company is not without its challenges. In particular, public companies face a host of regulatory requirements in connection with executive compensation. The compliance risks can be significant, as summarized below.

- **CHEAP STOCK.** The term refers to stock-based awards granted at artificially low prices preceding an initial public offering and creating a financial windfall for the grant recipient. Since private companies lack a public trading market to set the fair market value for their stock, the U.S. Securities and Exchange Commission will scrutinize evidence to support historical award valuations.

If the SEC concludes that the company's determination of fair market value used to set the exercise prices of stock options or to determine the value of

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[Table 1]
**MARKET CAP MEDIANS**

| Market Cap | Overhang | Potential Dilution | Burn Rate | Burn NEOs |
|---|---|---|---|---|
| $100-$250 million | 7.3% | 11.3% | 2.1% | 1.0% |
| $250-$500 million | 11.5% | 17.5% | 2.9% | 1.1% |
| $500 million-$1billion | 15.3% | 17.9% | 4.9% | 1.7% |
| $1billion-$2.5 billion | 12.3% | 14.5% | 2.9% | 0.6% |
| $2.5 billion-$5 billion | 7.3% | 13.0% | 1.7% | 0.7% |

*Source: Aon Hewitt*

stock awards was set below fair market value per share on the grant date, then it will require the company to recognize additional (and unexpected) compensation expense for issuing cheap stock.

For example, suppose a company grants stock options to employees at an exercise price equal to $5 per share. A year later, the company files its registration statement in preparation for an IPO. The SEC disputes the company's valuations and concludes that the fair market value of the company's common stock at the time of grant was actually $8 per share.

As a result, the company would be required to restate its financial statements to reflect the incremental $3 stock option fair value per share as compensation expense. While this is a noncash expense, it nonetheless reduces financial results and may adversely impact the market price for the company's IPO.

SEC staff routinely reviews all securities issued up to 18 months prior to the filing of the registration statement. The company bears the burden of proving that stock grants were indeed issued at fair market value at each grant date including, but not limited to, its valuation methodology and process, a chronology of historical equity award values and a reconciliation of management's fair value determinations and the current estimated IPO price range.

In short, the SEC is looking for a consistent valuation story or evidence corroborating anomalies.

**SECTION 409A.** Executives also feel the pinch from cheap stock. Section 409A of the Internal Revenue Code treats any stock option granted with an exercise price below the fair market value at the time of grant as a "discount stock option," thus subjecting individuals to an additional 20 percent income tax (plus potential interest taxes) on deferred compensation arrangements that do not meet specified criteria.

As a general rule, incentive stock options (ISOs) are exempt from Section 409A, but an ISO granted at a discount will lose its favorable tax status and may become subject to additional taxes under Section 409A.

For companies with relatively high valuations, consider granting full value awards such as restricted stock units in lieu of stock options. These awards are generally not subject to Section 409A (provided that shares are issued soon after the award becomes vested) and could minimize dilution since a fewer number of shares are required to satisfy a target opportunity value.

While there is no formal valuation guidance for reconciling fair values established under accounting standards and tax regulations, companies should act proactively and complete the necessary due diligence steps to preempt cheap stock issues and related tax risks.

**SECTION 162(M).** Section 162(m) of the Internal Revenue Code imposes a limit of $1 million per tax year on the deductibility of compensation paid to the chief executive officer and other named executive officers (excluding the chief financial officer). Stock options granted at-the-money and "performance-based" compensation are generally exempt from the deductibility limits.

New public companies can qualify for a special exemption if their registration statement discloses the company's compensation plans and agreements that exist at the time of the IPO. As a result, compensation payable and equity awards granted under those disclosed plans are exempt from Section 162(m).

This special exemption lasts until the first shareholder meeting at which directors are elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs (the "reliance period").

For example, a company grants time-vested restricted stock during the reliance period pursuant to a plan that existed (and disclosed in the registration statement) at the time

**[Table 2]**

**SECTOR MEDIANS**

| Market Cap | Overhang | Potential Dilution | Burn Rate | Burn NEOs |
|---|---|---|---|---|
| Energy | 11.9% | 18.8% | 4.4% | 1.4% |
| Industrials | 10.2% | 14.9% | 2.1% | 0.7% |
| Consumer Discretionary | 9.3% | 14.7% | 2.3% | 0.8% |
| Health Care | 10.4% | 15.5% | 2.9% | 1.2% |
| Financials | 10.4% | 14.1% | 3.2% | 0.8% |
| Information Technology | 16.5% | 20.0% | 3.9% | 1.1% |

*Source: Aon Hewitt*

of the IPO. In this case, the restricted stock grant would be exempt from Section 162(m) even if the stock ultimately vests after the end of the reliance period.

Similarly, stock options granted during the reliance period but exercised following the end of the reliance period will be exempt from Section 162(m).

Restricted stock units and phantom stock arrangements, however, do not enjoy the same relief. According to proposed U.S. Treasury regulations, unless restricted stock units and phantom stock arrangements are paid out prior to the end of the reliance period, such payments will be subject to the $1 million deduction limit under Section 162(m).

However, caution is advised before deciding to accelerate vesting of these awards since such action could pose adverse tax consequences to participants under Section 409A of the Internal Revenue Code.

**INSTITUTIONAL SHAREHOLDER SERVICES (ISS).** ISS provides voting recommendations on management and shareholder proposals that appear on a company's proxy statement covering director elections, independent auditors, equity plans, etc.

Effective for shareholder meetings beginning on or after Feb. 1, 2012, ISS will conduct a full equity plan evaluation when a company presents an equity plan on its ballot for the first time in order to obtain Section 162(m) shareholder approval following the end of the reliance period.

In the past, ISS would generally vote for plans that are submitted to shareholders for the purpose of exempting compensation from taxes under the provisions of Section 162(m) absent any additional share request. Now, ISS will conduct a full equity plan analysis including consideration of total shareholder value transfer, burn rate (if applicable), repricing and liberal change in control provisions.

For example, prior to this policy change, many pre-IPO companies adopted so-called "evergreen" plans. These plans automatically replenish the share reserve, thus circumventing the need for shareholder approval of new share requests.

Now, ISS will complete shareholder value transfer analysis, which would likely produce a higher stock plan valuation. And if the plan exceeds prescribed cost limits, the company faces the risk of receiving a vote recommendation from ISS opposing the approval of the company's stock plan.

## Equity Grant Practices

Going public provides management and the board of directors with a powerful incentive in the form of stock awards — a critical tool when considering that an IPO will generally trigger vesting acceleration of outstanding equity awards leaving employees vulnerable to poaching. Companies respond by issuing a special equity award to reestablish the alignment between shareholders and managers and strengthen employee retention.

A number of factors need to be considered before setting a reasonable aggregate grant level. For example:

- What is current share reserve?
- How much is the set-aside for a special IPO and ongoing grants?
- What are the company's equity needs to cover future participants as the company grows?
- How should grants be structured?
- What is an acceptable level of potential dilution and burn rate?

Aon Hewitt analyzed more than 100 IPOs in recent years to help guide deliberations regarding a special IPO grant and the size of the stock plan reserve. Table 1 (on opposite page) summarizes the median overhang (i.e., outstanding awards) and potential dilution (outstanding awards plus share reserve for future grant) levels organized by market capitalization based on its proprietary database.

On average, 4.2 percent of diluted common shares are reserved and available for a future grant. The burn rate — the total annual grant per year as a percentage of diluted common shares — at IPO is generally outsized compared to

“normal” grant patterns with named executive officers (NEOs) receiving nearly one-third of the total allocation.

Table 2 (above) summarizes the median overhang and potential dilution levels organized by industry sector. Not surprisingly, information technology companies top all other sectors in terms of potential dilution and are second only to energy when it comes to burn rates.

Nearly half of the companies reported in the database used more than one equity vehicle. While stock options continue to dominate the equity compensation landscape, one in five companies reported using full value awards. Some companies use a dual grant approach based on the individual’s position in the organization.

For example, some companies grant stock options primarily to executives while reserving full value awards for managers. This strategy recognizes an individual’s degree of influence on stock price and level of tolerance for financial risks.

“Going public” and “being public” is a tremendous undertaking requiring a multi-function team to address numerous governance, compliance and human resource issues.

Executive compensation, in particular, can support the IPO story or it can become a distraction, so start early. Identify pre- and post-IPO priorities to assist the executive compensation program, including a sound compensation framework based on pay-for-performance concepts and leading practices.

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