

Director pay in emerging firms

A snapshot of board compensation appropriately tailored to the organization's stage of development, industry, and size. **BY JOSEPH R. RICH**

FLEDGLING COMPANIES today must focus not only on obtaining the financial backing and technical expertise necessary to get their initiative off the ground, but also to put it on the right path from the standpoint of heightened new governance standards. In terms of attracting potential investors, firms may even find that there is an advantage to “acting public” when they are still private, even though they are not yet bound by new mandates.

Among the key initial challenges is the selection and compensation of a board of directors to best serve the emerging needs of the organization and, ultimately, of its shareholders. This article outlines board compensation practices and levels for emerging firms — those preparing for an initial public offering (IPO) — as well as pay practices and levels for newly public firms.

Preparing to go public

The recruitment, responsibilities, and composition of an emerging firm's board of directors must evolve to accommodate the company's changing needs, with corresponding adjustments to the level and structure of members' compensation, as outlined in Exhibit 1.

Let's examine each stage in the emergence of a new company:

Bootstrapping. There is usually not a formal board of directors in place at the very earliest stages of a company's formation. Angel and friends and family investors bring a keen interest in its success and may serve in an advisory role but have no expectation of compensation.

Professional Investment. Initial professional investors will expect to serve in a major advisory role

(and possibly as directors) to protect their interests but, like the earlier investors with a personal relationship to the founders, are not paid.

Market Validation. During this phase, some firms may recruit one or two outside directors with specific skills in the company's market or product area. The outside members may receive a very modest cash retainer, but the majority of their compensation will be in the form of stock options or, in some cases, as an opportunity to co-invest.

Preparing for an Offering. As the company anticipates its IPO, the specific composition of the board becomes more critical. Many organizations will recruit more experienced, “marquee” directors to add credibility and stature to the venture, as well as to bring the board in line with the stricter requirements for director independence that apply to public companies. The main carrot for attracting such candidates is the opportunity to participate in meaningful stock appreciation, since compensation levels and structures at this stage — while similar to what we might see in a public company — are relatively modest with respect to cash and make more use of stock options.

Offering. What eventually drives change

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in board pay practices and growth in the level of pay is the need to attract and retain independent directors to meet stock exchange listing requirements, particularly for members who are demonstrable experts in specific fields such as financial statement auditing. Director pay then becomes more differentiated, including the adoption of specific fees and retainers for service on particular committees to reflect differences in members' responsibilities for complying with new governance requirements.

Newly public firms

Once a company goes public, board compensation becomes more differentiated by size and industry. To illustrate these differences, we looked at the board compensation levels and practices of 10

newly public firms in industry/size groups: small life science firms, small information technology firms, and larger cross-industry firms. All of the firms in our sample have been public less than one year (see Exhibit 2).

Board retainers are generally the largest cash component, with values typically correlating with firm size. Exhibit 3 outlines board retainers in the three sub-samples. Retainers in the larger cross-industry firms are 50 percent to 80 percent greater than in the smaller firms.

Board meeting fees also become differentiated by firm size and, to a lesser extent, by industry, as outlined in Exhibit 4. But few new companies provide components such as committee retainers or meeting fees, which are generally adopted by more mature firms.

EXHIBIT 1: Director compensation in emerging firms

| Stage of Development | Bootstrapping (Prior to Professional Investment) | Professional Investment |
|-----------------------------|--|---|
| Work Focus | Idea and business plan development. Funding from personal, friends, and/or family resources. Work focuses on initial proof of concept. | Initial funding from professional (i.e., private equity or venture capital) investors. Work focuses on initial product development. |
| Board Role/Focus | Limited role, typically advisory in nature. Many firms have no outside directors at this point. | Investment oversight; advice and counsel to founders/ executives. May include assistance from technical advisers. |
| Composition of Board | Founders. May include "angel" or friends and family investors. | Some or all founders, investor representatives. As new investment rounds progress, new investor representatives may join the board. May include technical advisers, or a separate technical advisory board. |
| Cash Compensation | Typically none. | Typically none. |
| Stock Compensation | Typically none (assuming no outside independent directors). | Typically none (assuming no outside independent directors). |

Among the smaller firms, equity compensation is very significant. Initial grants made upon appointment or election to the board typically represent approximately 0.1% of shares outstanding in both the life science and information technology firms, with a value of approximately \$140,000 among information technology firms and nearly \$280,000 among life science firms. Annual ongoing grants are typically half or less of the initial grant. Cross-industry firms were less likely to grant equity, with correspondingly and substantially lower values.

Where board comp goes from here

Smaller, newly public firms may be less complex than larger firms, but directors' time commitments nevertheless will increase significantly post-IPO owing to increased compliance responsibilities,

EXHIBIT 2: Revenue and market capitalization of newly public sample firms

| | | Annual Revenue, Trailing 12 Months (\$M) | Market Capitalization as of 1/23/07 (\$M) |
|---------------------------|---------|---|--|
| Life Science | Median | \$57 | \$504 |
| | Average | \$88 | \$752 |
| Information Technology | Median | \$117 | \$675 |
| | Average | \$112 | \$693 |
| Cross Industry | Median | \$1,424 | \$1,220 |
| | Average | \$1,791 | \$1,447 |

Market Validation

Continuing product development; distribution and revenue stream development. Work focuses on moving to profitability (or, in a life science firm, moving through FDA approval stages).

Investment oversight; advice and counsel to founders/ executives; providing specific assistance with respect to marketing, business development.

Founders, CEO, investor representatives. May include outside directors with specific experience in the target market.

For outside independent directors, modest cash compensation (typically an annual retainer of \$5,000 to \$15,000).

For outside independent directors, 0.25% to 0.75% of shares outstanding, typically provided in stock options, typically granted upon election.

Preparing for an Offering

Six to 12 months prior to an offering. Focus is on demonstrating consistent revenue growth and profitability.

Investment oversight; advice and counsel to founders/ executives; guiding the executive to an offering. Recruitment of outside independent directors to prepare the firm for post-offering governance.

Founders, CEO, investor representatives, outside independent directors.

For outside independent directors, modest cash compensation (typically a \$10,000 to \$30,000 annual retainer). May also include committee retainers (\$3,000 to \$5,000) and meeting fees (\$500 to \$1,000 per meeting).

For outside independent directors, 0.10% to 0.50% of shares outstanding, typically provided in stock options, granted at election, and with the expectation of ongoing annual grants.

Post Offering

Ongoing market validation.

Shareholder representatives, advice and counsel to executives, governance.

CEO, outside independent directors. Investor representatives typically step down as their investments are monetized.

For outside independent directors, modest cash compensation (typically a \$20,000 to \$30,000 annual retainer). May also include committee retainers (\$3,000 to \$5,000) and meeting fees (\$500 to \$1,000 per meeting).

Stock compensation typically expressed as a dollar value (rather than a percent of shares outstanding). Stock value is generally more than cash compensation and typically provided in the form of stock options. Larger firms may also use restricted stock. Grants are typically made at election and annually thereafter.

EXHIBIT 3: Board retainer

| | Average | Median | Prevalance |
|------------------------|----------|----------|------------|
| Life Science | \$24,100 | \$20,500 | 90% |
| Information Technology | \$21,111 | \$25,000 | 80% |
| Cross Industry | \$36,350 | \$38,000 | 100% |

EXHIBIT 4: Board meeting fees

| | Average | Median | Prevalance |
|------------------------|---------|---------|------------|
| Life Science | \$600 | \$0 | 40% |
| Information Technology | \$944 | \$1,000 | 50% |
| Cross Industry | \$1,100 | \$1,000 | 60% |

particularly at the committee level and most particularly for audit and compensation members. Moreover, smaller firms will tend to have smaller boards to handle the same issues and committee requirements faced by larger boards — as well as facing increased risk, since smaller firms may have fewer resources to support board members. That makes it important to attract and retain highly qualified and energetic board members.

And while few board members are likely to be

motivated primarily by compensation, it is important to recognize their contributions to the success of the firm. Tailoring board compensation to the organization’s stage of development, industry, and size is key to ensuring the kind of appropriate pay arrangements that are viewed today as a critical measure of good governance. ■

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