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Through a Different Lens: Retaining and Engaging Talent Through Alternative Equity Programs

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SESSION AGENDA

- Competitive Landscape
  - What companies planning to IPO as an exit are doing for equity
- Case Studies*
  - Proposed equity program design
  - Assessment and alternative identification
  - Roles and responsibilities
  - Communication
  - Results

Survey data from the 2012 Private Company Equity Compensation Survey Results by the National Center for Employee Ownership. Visit **www.nceo.org for more information.*

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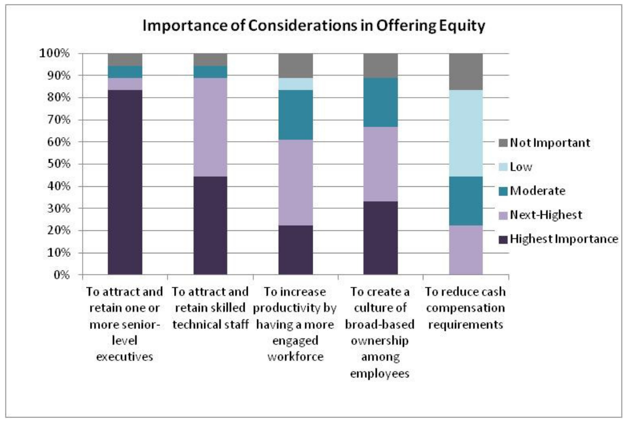
THE COMPETITIVE LANDSCAPE

- Even companies that plan to IPO have a range of reasons for offering equity to employees



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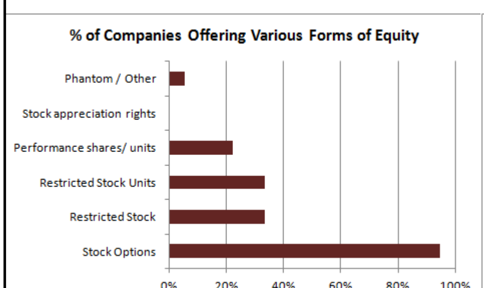
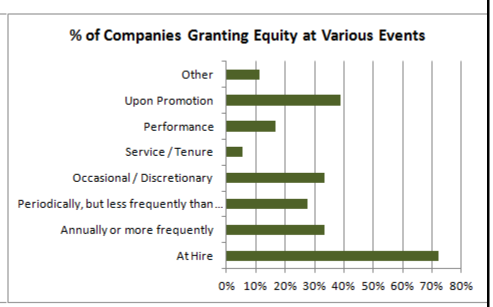
THE COMPETITIVE LANDSCAPE

- How the considerations translate to form and timing of grants even varies by company
- But, we certainly know that RS/RSUs are more common than ever; stock options are not the only game in town
- And, events that may trigger a grant vary by company





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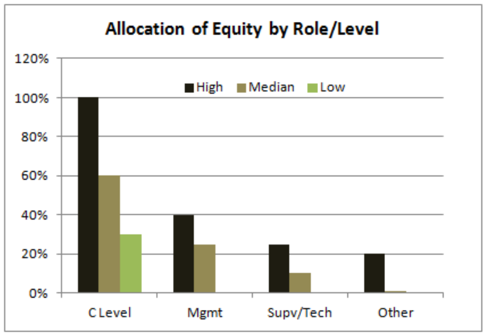
THE COMPETITIVE LANDSCAPE

- Companies vary widely in how the pool of equity is distributed among various roles and levels in the company



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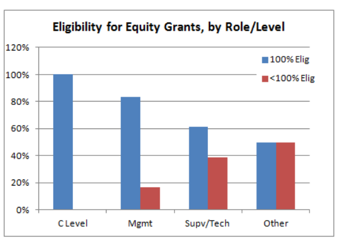
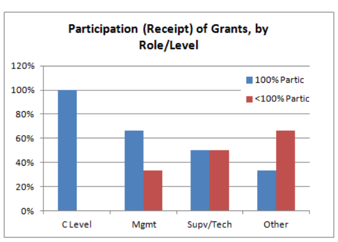
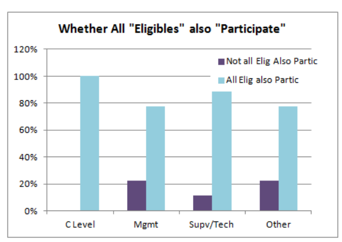
THE COMPETITIVE LANDSCAPE



- Eligibility and participation follow similar patterns





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Case 1: Maturing the Equity Program

- Current stock program for executives had several challenges
- New approach desired to improve on 5 key areas:
  - Reduce share utilization, burn rate, dilution
  - Allow executives to realize intended value
  - Eliminate time-vested equity grants
  - Optimize efficiency – value realized versus expense
  - Compelling story for current and prospective executives
- At the same time, the company needed to balance other objectives and could not withstand major changes all at once

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Case 1: Design Evolution

Factor	Determining Considerations
Performance-based	• All other things equal, satisfy external pressure for this
Form of award	• Options expiring out of the money is worst case scenario • Variability of cash-settled is less efficient for company but protects executives
Overlapping vs book-end grants	• Keep execs engaged through an "off" cycle • Recognize inability to set multi-year financial goals • Predictable reported equity expense in proxy
Performance metrics	• Ensure outcomes/results, not efforts, are rewarded • Financial and TSR are inarguable measures of results
Absolute vs relative performance	• Industry consolidation, combined with huge performance swings among peers, limits value of relative • Over the long term, absolute TSR will be as good a measure of relative performance
Vesting	• Mimic pattern of 3-year RSU + 4-year option vesting • Compromise vs alternative of all 3-year vesting

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Case 1: Design Evolution

Move to desired program in Year 1 was not feasible; a phased approach also allowed recalibration before adopting the "final" design

Year 0 – Two types

- 50% NQ/ISO 4-year annual vesting
- 50% RSU 3-year annual vesting

Year 1 – Three types

- 33% NQ/ISO 4-year annual vesting
- 33% RSU 3-year annual vesting
- 33% "Financial" RSU 1-year performance and 3-year vesting

Year 2 – Two types

- 50% "Financial" RSU 1-year performance and 3-year vesting; cash-settled
- 50% "TSR" RSU measure and vest at 1, 2, 3, & 4 years

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Case 1: Lessons Learned

- Management-driven was an advantage
  - Multidisciplinary team was prepared for accounting, reporting, administration
  - Even still, a few misses, such as high restoration matches from cash-settled plan
  - Started from business and human capital issues
  - Compensation Committee understood issues and focused on the right issues; Chair was "brought along"
- …and management-driven was a challenge
  - CEO / inner circle discouraged testing with wider group
  - Elegance and simplicity were not fully optimized

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Case 1: Lessons Learned

- Mixed alignment to business/talent strategies
  - Doubling-down on annual financial goals with bonus plan
  - Reduced emphasis on retention cuts both ways
  - Retained the flexibility to do unique things for unique candidates while honoring the overall program
- Phased approach had real downsides
  - Difficulty knowing what each grant was, and why
  - Destination was right, but a shorter path would have more closely met the business objectives

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Case 1: Lessons Learned

- Communications
  - Challenge translating design to layman's terms
  - Needed less "because" and more "why"
  - Fine-tuned to reinforce company culture and vision
- Implementation
  - Ready, willing and able, but really labor-intensive
  - Broker tracking and reporting less than perfect
  - Simple tools for participants pivotal for recruitment, engagement, and pay-for-performance linkage
  - Going through audit and controls was enlightening; should have done this at the front end

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Case 2:
Pre-IPO RSUs

- Vesting contingent on service + liquidity event
  - Quarterly/annual "earning" events
  - Terminated employee retain rights to earned shares
  - If/when liquidity event occurs, six months AFTER liquidity event, earned shares VEST and are released

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Case 2:
Pre-IPO RSUs

- Rationale / Pros
  - Avoids breaching shareholder rule
    - Exercised options = shareholders
  - Avoids repricings, underwater options
  - Lower number of shares used (full value)
  - Lower dilution (until liquidity event occurs)
  - No expense until liquidity event
  - Avoids 409A (not vested, so not deferred)
  - No investment decision – no cash paid
    - May limit amount of information that must be communicated to employees

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Case 2:
Pre-IPO RSUs

- Challenges
  - Tracking terminated employees for years after termination
  - W-2 income – earned as an employee
  - Which tax rates should be used (earned years before vest/release)
  - Huge tax burden at release
    - Withholding shares for taxes = company "gets" to pay taxes
    - Limits dilution somewhat
  - International employee tax calculations, mobility challenges
    - No tax treaty = other issues

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Case 2:
Pre-IPO RSUs

- Challenges
  - Systems cannot always support "delayed vesting"
  - Accounting
    - FIN 28
    - Enormous expense in period of liquidity event
    - Diluted EPS calculations are complex
  - Employee communications
    - Including current value of equity in comp statement
    - Part of company culture
    - Post current fair market value on intranet

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Case 2:
Pre-IPO RSUs

- Grant agreement
  - Putting actual earn/vest dates and number of shares into grant agreement would have been easier
- Treatment for Leave of Absence
  - Suspend/toll vesting?
    - Administratively burdensome

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Case 2:
Important Take-Aways

- ALWAYS consider the administrative issues when deciding on a new equity instrument or design
- Before jumping on the bandwagon, because everybody else is doing it, make sure changes make sense for your company
- Think through, document, and clearly communicate all the Pros AND the Cons before moving forward
- Create clear documentation for all new processes, such as tracking terminated employees who will be eligible to receive shares

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Case 3:
Bookend Vesting (aka Boxcar Vesting)

- History
  - Company had a long-standing, well-received annual equity refresh program
  - Board member proposed a new equity program without support from management

- Proposed Program Design Change
  - Current Program:
  - Current program provided an annual grant for employees once they reached 50% vesting.
  - Amounts were determined based on level with a performance multiplier to reward top performers.
  - Refresh option grants vested over 4 years at a rate of 1/48th per month.

  - Proposed Program:
  - Bookend Vesting program provided refresh grants annually after 25% vesting however new grants had a three year delay to begin vesting.
  - Annual refresh grants vest over 1 year (1/12 per month) starting on the day the last grant provided to the employee ceases vesting.

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Case 3:
Challenges

- Roles and Responsibilities
  - Board was dictating program design rather than setting strategy.
  - We were seemingly alignment on program objectives which raised concerns that there were unstated objectives the Board was trying to achieve (aka saving shares).
- Intellectual Elegance vs Practical Application
  - Theoretically, bookend refresh program provided smooth layering of unvested equity and would promote long term retention.
  - The practical application created a huge dip in vesting for key employees with the change to the new vesting approach.
- Lack of Management Support
  - Management had serious concerns about the new program both for themselves and the employees.
  - Management had concerns that it would increase voluntary attrition rates.
- Marketing the New Program
  - How were we going to market the program to employees when it would likely feel like a takeaway to them?

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Case 3: Reframing the Proposal

- State concerns and then get on the same side of the issue
  - Align on objectives
  - Understand stated and unstated drivers
- Model the Design and Educate
  - Understand how it really would work in its application with the program change from the previous vesting model
- Identify Potential Alternatives

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Case 3: Key Take-Aways

- Roles and responsibilities between the Board and Management
- Understand and align on objectives
- Understand the immediate consequences and multi-year implications
- Be aware of opportunities that present themselves to redirect to the desired outcome
- If you can't redirect the outcome, commit to the program and focus on education, marketing, and clear ongoing communication to employees to drive value

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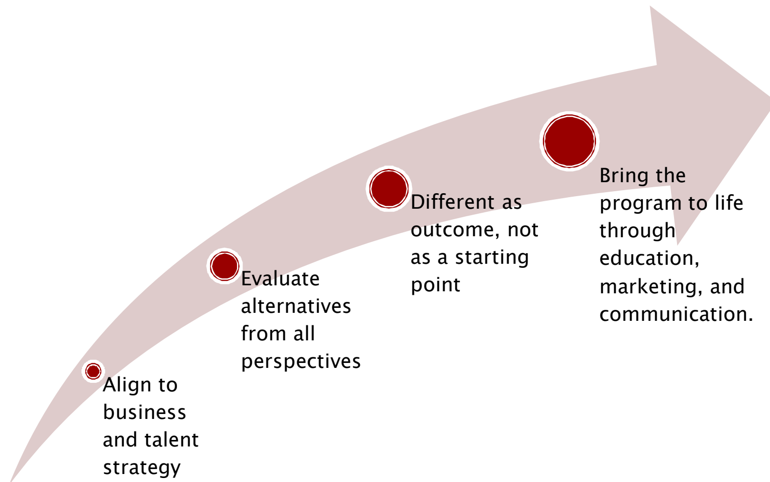
Lessons and Take-Aways



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