Private Company Executive Compensation Demystified

UNRAVELLING THE COMPLEXITY OF PRIVATE COMPANY COMPENSATION PRACTICES

Contents

Executive Compensation for Privately Owned Companies

Private companies face unique challenges in establishing appropriate compensation levels for executives, including a lack of quality data, unique ownership structures, governance structures that may not be fully mature, and stakeholders who may have limited related business experience.

CHALLENGES IN EXECUTIVE COMPENSATION

Lack of Quality Data

Private companies often struggle to find reliable — and appropriate — compensation benchmarks.

Unique Ownership Structures

Variations include founder-owned, family-owned, employee-owned, and investor-owned companies, each with distinct needs.

Governance Structures

Many private companies have evolving governance frameworks that may not fully support compensation decisions.

Stakeholder Savvy

Stakeholders may lack the specialized experience needed to understand and support compensation strategies.

This report offers insights into establishing market pay levels, interpreting them for your company, and interfacing with stakeholders. Read on for strategies companies can use to navigate these challenges.

STRATEGIES FOR NAVIGATING CHALLENGES

Overcoming the complexities of executive compensation requires a strategic approach that considers various components and stakeholder interests. Here is a guide to understanding and managing these challenges effectively:

Understand Executive Compensation Components

Executive compensation typically includes a variety of components:

- **Salary** is the annualized base salary.
- **Short-term incentives/bonuses (STI)** include the most recent actual paid and target award opportunities with a performance period of one year or less.
- **Total cash compensation (TCC)** is salary plus any STI earned.
- **Long-term incentives (LTI)** include cash plans (with a performance period longer than one year), synthetic stock plans such as options, full-value stock awards, and any other types of incentives.
- **Total direct compensation (TDC)** represents the sum of salary, STI, and LTIs for each incumbent.
- **Other compensation arrangements** such as deferred compensation arrangements and capital accumulation plans.

Interpret Market Pay Levels

It is important to obtain quality data; however, it can also be difficult to interpret the data. To start, you may want to conduct:

- **Benchmarking:** Leverage compensation surveys and industry reports to establish market pay levels.
- **Peer Comparisons:** Analyze compensation practices of similarly situated private companies to gain insights. This is often a major challenge for private companies, given the lack of readily available data for other private companies.

Factors impacting pay levels and design include organizational size, industry, and ownership structure. Once you have your data, apply it to your company's specific situation and strategy through:

- **Customization:** Tailor compensation packages to align with company goals and culture.
- **Flexibility:** Consider a mix of salary, bonuses, and equity to attract and retain talent.

Gain Insights from Other Private Companies

As comedian Steven Wright said, "Experience is what you get just after you need it." Obtaining insights from others who have faced similar challenges enables you to learn from their experience. Sources may include:

- **Advisory boards:** Utilize advisory boards to provide external perspectives on compensation practices.
- **Networking:** Engage with industry groups and forums to share experiences and strategies.
- **Consultants:** Hire a neutral third party to review and make recommendations regarding compensation arrangements.

Read on to find real examples of the type of conundrums leaders face when they seek to address gaps in their compensation levels or plan design.

> *Customizing compensation packages is a nuanced process that is highly dependent on circumstances. By and large, "best practices" may serve to guide but not dictate the design.*

JUDY CANAVAN
Global Employer Services Managing Director

Interface with Stakeholders

Some stakeholder categories are similar across all types of companies, such as customers/clients, employees, board members, the local community. However, company structure can significantly impact the nature of the stakeholders.

For private companies, stakeholders who differ from those of publicly held companies may include:

- Family members
- Friends who invested
- Active business partners
- Silent partners
- Employees as more prominent stakeholders (especially in the case of an ESOP)
- Venture capital (VC) or private equity (PE) investors

Maintaining relationships and gaining support for decisions can present unique challenges; potential strategies typically involve:

- **Education:** Provide stakeholders with clear explanations of compensation strategies and their alignment with company objectives.
- **Transparency:** Maintain open communication to build trust and support for compensation decisions.

Case Study: Second Generation Takes the Reins

Challenge: A group of friends purchased a business, with one investor managing it and later training his son to take over. This arrangement worked well until all the original, non-managing investors passed away within a two-year period, leaving ownership to their children, who lacked the historical context necessary to understand the business. Frustrated by their inability to access the substantial principal value, the inheriting owners raised numerous questions at board meetings about management decisions and compensation, driven by expectations regarding distribution size and returns.

Approach: To address these challenges, BDO was brought in as a neutral third party to evaluate the compensation structure, focusing on the annual incentive. BDO engaged with the board, helping to ensure that members felt involved and heard. Immediate and long-term revisions to the incentive plan were proposed, including suggested guardrails to help ensure that payouts occurred only if performance exceeded a certain threshold and capping windfalls.

Result: Building trust takes time, and this was a crucial step towards establishing a trusting relationship between management and the next generation of ownership.

Key Drivers of Executive Compensation

There is no one absolute market pay rate for a position. The four key influences on pay levels are organizational size, industry, geographic location, and ownership structure. Determining reasonable pay levels requires consideration of these elements. BDO's Private Company Executive Compensation Survey analyzes pay data of four executive roles based on these factors. This white paper highlights key findings focusing primarily on the CEO role. Results are analyzed to determine the influence of organizational size, industry, geography, and ownership structure. Key trends from the 2024 survey results are provided below.

CEOs AT LARGER COMPANIES TEND TO BE PAID MORE

CEO pay is typically higher at larger companies, due to both the financial scale and the increased complexity of the role. Figure 1 below compares the CEO pay for a cohort of larger companies to that of smaller companies to illustrate the impact of company size.

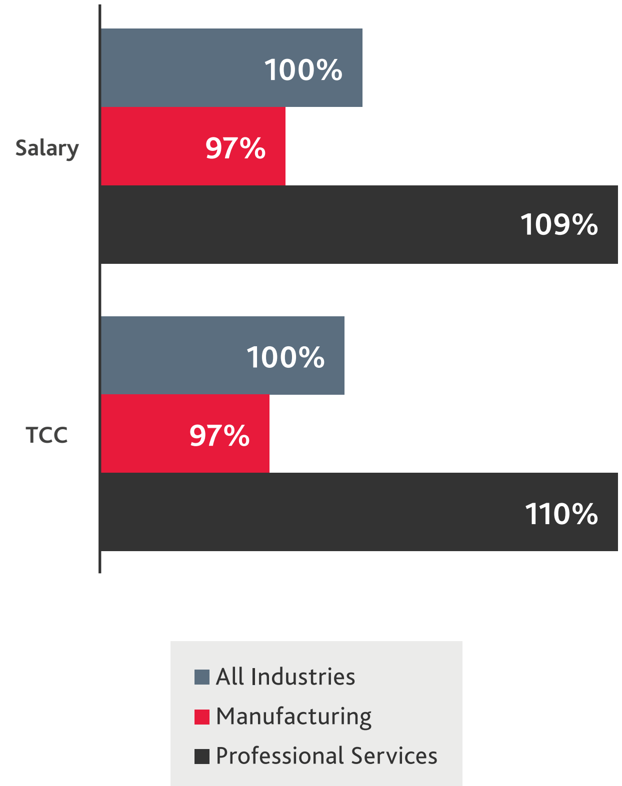
FIGURE 1: Differential of Median CEO Pay for Private Companies With Revenue $50M-$100M vs. Under $25M

Revenue Range	Salary	Actual TCC	TDC
Larger Companies CEO Pay As a % of Smaller Companies	131%	142%	154%

PAY VARIES WIDELY BY INDUSTRY

Industry is a key driver of compensation. Pay differentials for salary and TCC in the manufacturing and professional services industries are highlighted in Figure 2 to the right. On a salary basis, professional services CEOs earn 109% (a 9% premium) compared to all industry CEOs, while manufacturing CEOs earn 97% (a 3% discount) compared to all industry peers. The trend is similar for TCC, with professional services CEOs receiving 110% compared to all industry CEOs (a 10% premium), and manufacturing CEOs earning 97% (a 3% discount). We controlled for size by focusing on companies with revenues between $100 million and $500 million.

FIGURE 2: Differential of Median CEO Pay by Industry Compared to Overall Private Company CEO Pay



CEOs IN LARGE METRO LOCATIONS TEND TO BE PAID MORE

CEOs in large metro locations generally earn more than their counterparts outside of those locations. The premium for large metro area CEOs is most pronounced in the $100 million to $500 million revenue range; those CEOs earn 21% more than their counterparts in smaller metro areas.

FIGURE 3: Differential of Median CEO Pay in Large Metro Locations Compared to Other Locations

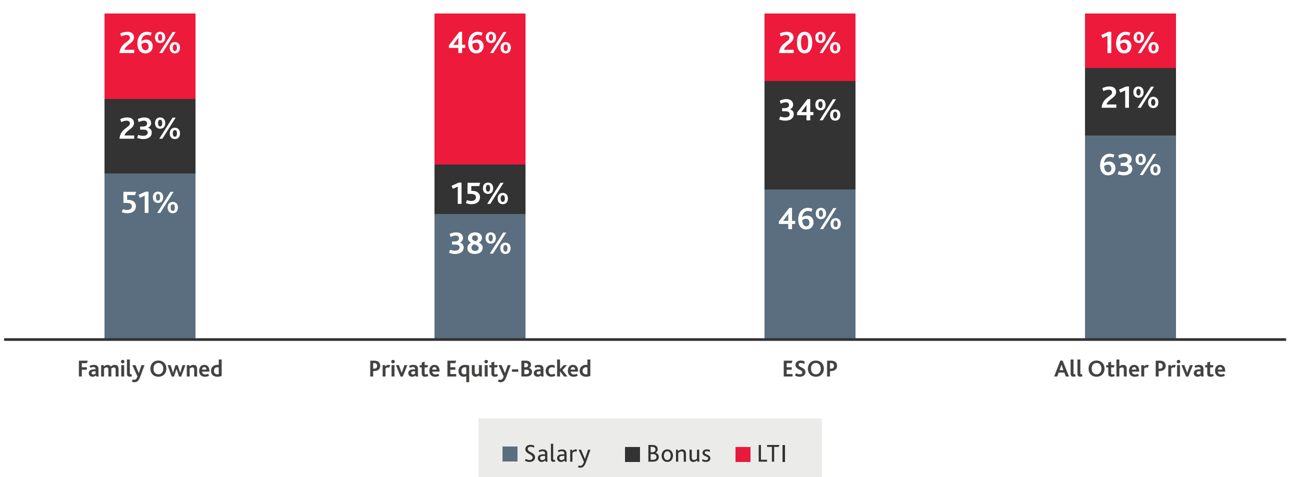
Revenue Range	Salary	Actual TCC	TDC
Under $25M	109%	109%	104%
$100M - $500M	95%	114%	121%

Based on the top 11 metropolitan statistical areas reported in the survey.[1]

FAMILY-OWNED COMPANIES FAVOR SALARY, WHILE PRIVATE-EQUITY-BACKED COMPANIES FAVOR LTI

Among companies with $100 million to $500 million in revenue, the pay mix for CEOs varies depending on the company ownership type. For example, private-equity-backed companies weigh pay more heavily towards LTIs than any other ownership structure, aligning with their investment ethos. Family-owned and other private companies weigh salary more heavily.

FIGURE 4: CEO Pay Mix by Ownership Type



1 New York-Newark-Jersey City, NY-NJ-PA / Washington-Arlington-Alexandria, DC-VA-MD-WV / Chicago-Naperville-Elgin, IL-IN-WI / Philadelphia-Camden-Wilmington, PA-NJ-DE-MD / Milwaukee-Waukesha, WI / Grand Rapids-Kentwood, MI / Los Angeles-Long Beach-Anaheim, CA / Madison, WI / Miami-Fort Lauderdale-Pompano Beach, FL / Boston-Cambridge-Newton, MA-NH / Dallas-Fort Worth-Arlington, TX

Case Study: Aligning Interests Without Ownership Transfer

Challenge: A midsized manufacturing company is entirely owned by a single investor, who is pleased with his management team. The CEO proposed creating a long-term plan to allow the leadership team to share in future gains and align their interests with those of the owner. However, the owner wanted to retain his ownership stake.

Approach: The company explored two plan options:

- Deferred Compensation Plan: Funded based on the current operating margin.
- Performance Unit Plan: Based on three years of performance.

Key considerations included the cost and whether sufficient funds were available for payouts. The deferred compensation plan relied on current performance, while the performance unit plan depended on future performance, which might not guarantee adequate funding. Both plans would require legal and accounting advice to avoid potential negative consequences under IRC Section 409A.

Result: The company now had two potential approaches that aligned with its objective of sharing the returns generated with the senior management team.

FOR FAMILY-OWNED COMPANIES, PAY MIX VARIES BASED ON THE NUMBER OF GENERATIONS

Among family-owned companies, pay mix for CEOs varies depending on the number of generations of ownership. In the beginning, the CEO is often the founder and largest shareholder. Pay is minimal as profits are reinvested in the business and/or taken as shareholder distributions. CEO variable compensation increases with each successive generation of ownership. In our experience, CEO compensation begins to align more closely with broader market practices over time, with variable compensation becoming an important tool to reward CEOs for generating returns for the family owners.

The 2024 survey results showed that median CEO company ownership decreased with each successive generation of ownership, as ownership is often diluted among family members over time, thus increasing the need for other forms of variable compensation to continue to retain and incentivize the family members who remain active in the business.

FIGURE 5: CEO Pay Mix by Ownership Generation

	Pay Element as % of Total		
Ownership Generation	**Salary**	**Variable Compensation**	**Median CEO Ownership**
1st Generation	87%	13%	60%
2nd Generation	77%	23%	11%
3rd Generation	67%	33%	0%

Case Study: CEO Family, but Not Owner

Challenge: A private manufacturing company is run by the second-generation CEO. The company is owned by the CEO's father and another investor. As a result of the close relationships, conversation about pay can be awkward. The father appropriately steps back from these discussions; however, the investor views the father's ownership as the same as if the CEO had direct ownership, which impacts his view on the CEO's compensation.

Approach: BDO was hired to assess the competitiveness of the CEO's compensation, including salary, bonus, and long-term incentives. To establish a competitive pay range, BDO recommended that the company implement a long-term plan, either through synthetic equity or cash.

Result: The new approach facilitated the conversation about pay and provided a mutually agreeable plan for targeting competitive pay that aligned the interests of the CEO and the outside investor.

Five Compensation Plan Design Pitfalls to Avoid

Designing an effective compensation plan involves avoiding several common pitfalls. Here are some considerations to help enhance your approach:

Complexity in Compensation

Avoid oversimplifying by just offering a salary and profit percentage. As your company grows, this can lead to excessive payouts, attracting Internal Revenue Service attention and potentially upsetting shareholders who may feel their returns are compromised.

Proactive Transition Planning

Invest in educating future company leaders early. Don't wait until transitions become urgent; proactive education can contribute to smoother leadership changes and continuity.

Regulatory Compliance

Verify that all plans comply with regulations like IRC Section 409A, which governs compensation promised in one year and paid in another. Engage a specialized attorney and accountant to review your plans, as demonstrated experience in this area is crucial to avoid legal issues.

Strategic Decision-Making

Base compensation decisions on data and strategic goals, not arbitrary methods. This can help promote alignment with company objectives, credibility, and fairness.

Alignment with Strategic Objectives

Design incentive metrics that support long-term goals. Avoid metrics that might discourage essential investments in infrastructure or other critical areas.

By focusing on these strategies, you can develop a compensation plan that strives to be fair, compliant, and aligned with your company's strategic vision.

Where to Turn for Guidance and Advice

When a company is launched, the founder often relies on personal experience and knowledge to build the business. Initially, the CEO may also serve as the CFO, head of sales, head of marketing, chief innovator, and/or HR leader. Over time, the organizational structure evolves, and a team is formed to support or lead these functions. Eventually, the leadership team encounters challenges that require specialized guidance, which can come from friends, consultants, or the addition of a board.

In the dynamic landscape of private companies, governance structures are crucial for steering businesses toward success. Among these, fiduciary and advisory boards are key components. Understanding their roles, benefits, and differences helps companies leverage these boards effectively.

ESTABLISHING A BOARD

Private companies may have a board composed of shareholders. That board may reach a point when additional guidance is needed. This can be triggered by events such as acquiring another company, planning a liquidation event, or changing the company's strategic direction.

There are two types of boards: fiduciary and advisory.

Fiduciary Boards

A fiduciary board is a governing body responsible for overseeing the management of a company. It has a legal obligation to act in the best interests of the company and its shareholders. The primary duties of a fiduciary board include:

- **Strategic Oversight:** Setting long-term goals and ensuring alignment with the company's mission and vision, while also aligning with best practices observed in public boards.
- **Financial Accountability:** Monitoring financial performance and ensuring accurate reporting.
- **Risk Management:** Identifying potential risks and implementing strategies to mitigate them.
- **Compliance:** Ensuring adherence to legal and regulatory requirements.

Ideally, fiduciary boards should include independent board members, not just shareholder members, to provide diverse perspectives and enhance governance.

Additionally, private companies can use the governance 'best practices' observed among public boards as guide for establishing their own fiduciary board and governance practices.

Advisory Boards

An advisory board, unlike a fiduciary board, does not have legal responsibilities or decision-making authority. Instead, it offers non-binding strategic advice and knowledge to the company's management. Key functions include:

- **Knowledge Sharing:** Providing insights and skills in specific areas such as technology, marketing, or international expansion.
- **Networking:** Facilitating connections with industry leaders and potential partners.
- **Innovation Support:** Offering fresh perspectives and innovative ideas to drive growth.

THE COMPETITIVE LANDSCAPE

Based on the results of the 2024 Private Company Executive Compensation Survey, we found that:

- About 70% of the participating companies have a board of some type.
- Fiduciary boards are significantly more common than advisory boards (about twice as many companies in the survey had fiduciary boards rather than advisory boards).
  - Companies with revenues over $50 million were more likely to have a fiduciary board than those below $50 million (58% versus 48%).
  - By the fourth generation, 70% of companies have a fiduciary board, while companies with management by earlier generations tend to hover at or below 40%.
- Firms backed by private equity or venture capital are highly likely to have a board (67%), second only to ESOPs (82%), which are typically required to have a board.

PREVALENCE OF BOARDS BY OWNERSHIP

	Company Ownership			
	Family Owned	ESOP	Private Equity or Venture Capital Backed	Other Private
Number of Companies in Sample	**208**	**90**	**85**	**157**
% of companies with fiduciary board	37%	82%	67%	46%
% of companies that pay fiduciary board members	45%	82%	47%	42%
% of companies with advisory board	30%	30%	26%	31%
% of companies that pay advisory board members	65%	74%	50%	41%

PREVALENCE OF BOARDS BY SIZE

	Company Revenues	
	<$50M	$50M +
Number of Companies in Sample	**252**	**257**
% of companies with fiduciary board	48%	58%
% of companies that pay fiduciary board members	47%	58%
% of companies with advisory board	31%	30%
% of companies that pay advisory board members	50%	60%

A BLUEPRINT FOR SUCCESS

Establishing executive compensation in privately owned companies requires careful consideration of unique challenges and strategic use of data and insights. By benchmarking against market standards, leveraging peer insights, and engaging stakeholders, private companies can create effective compensation strategies that support growth and success.

Case Study: Female CEO Gets a Raise

Challenge: A female CEO suspected she might be underpaid but was unsure how to validate her concerns. She was also reluctant to divert time from managing her successful business to research the issue.

Approach: The CEO received an email invitation to participate in the BDO Private Company Executive Compensation Survey. After completing the survey, she obtained the results. Although the data was extensive, she attended a presentation where she learned how to interpret it effectively.

Result: Armed with this understanding, she presented the findings to the board and was awarded a significant raise!

About the Survey

BDO's 2024 Private Company Executive Compensation Survey analyzes pay — including salaries, bonuses, and long-term incentives — for CEOs, CFOs, heads of operations (COOs), and top sales/marketing executives. Survey participants are eligible to receive the full survey participant report, which provides pay data calibrated by factors such as company size, industry, and ownership structure. The survey also covered ESOP arrangements and the use of fiduciary or advisory boards.

All data was collected between April and June 2024 using an online submission tool. To help achieve high-quality results, all submissions were reviewed by BDO's compensation survey team. Unusual or outlier responses were flagged and clarifying questions were sent to the participants. Data is held in strict confidence and no individual data is disclosed.

The following provides an overview of the survey participants by industry, size, and type of ownership.

Industry

The industries with the largest representation in the survey are shown below.

Industry	Number of Participants	Percentage of Overall Participation
Overall (Total)	**563**	**100%**
Manufacturing	119	21%
Professional Services	76	14%
Construction	49	9%
Wholesale/Distribution	49	9%
Life Sciences/Pharma/ Healthcare	47	8%
Technology	46	8%

Company Size

Our survey uses annual revenue, or assets in the case of financial services institutions, as the scope factor for size. Participating private company distribution by size is as follows.

Revenue Range	Number of Participants	Percentage of Overall Participation
Under $25M	167	30%
$25M-$50M	85	15%
$50M-$100M	82	15%
$100M-$500M	127	23%
$500M-$1.25B	34	6%
$1.25B-$3B	8	1%
Over $3B	6	1%

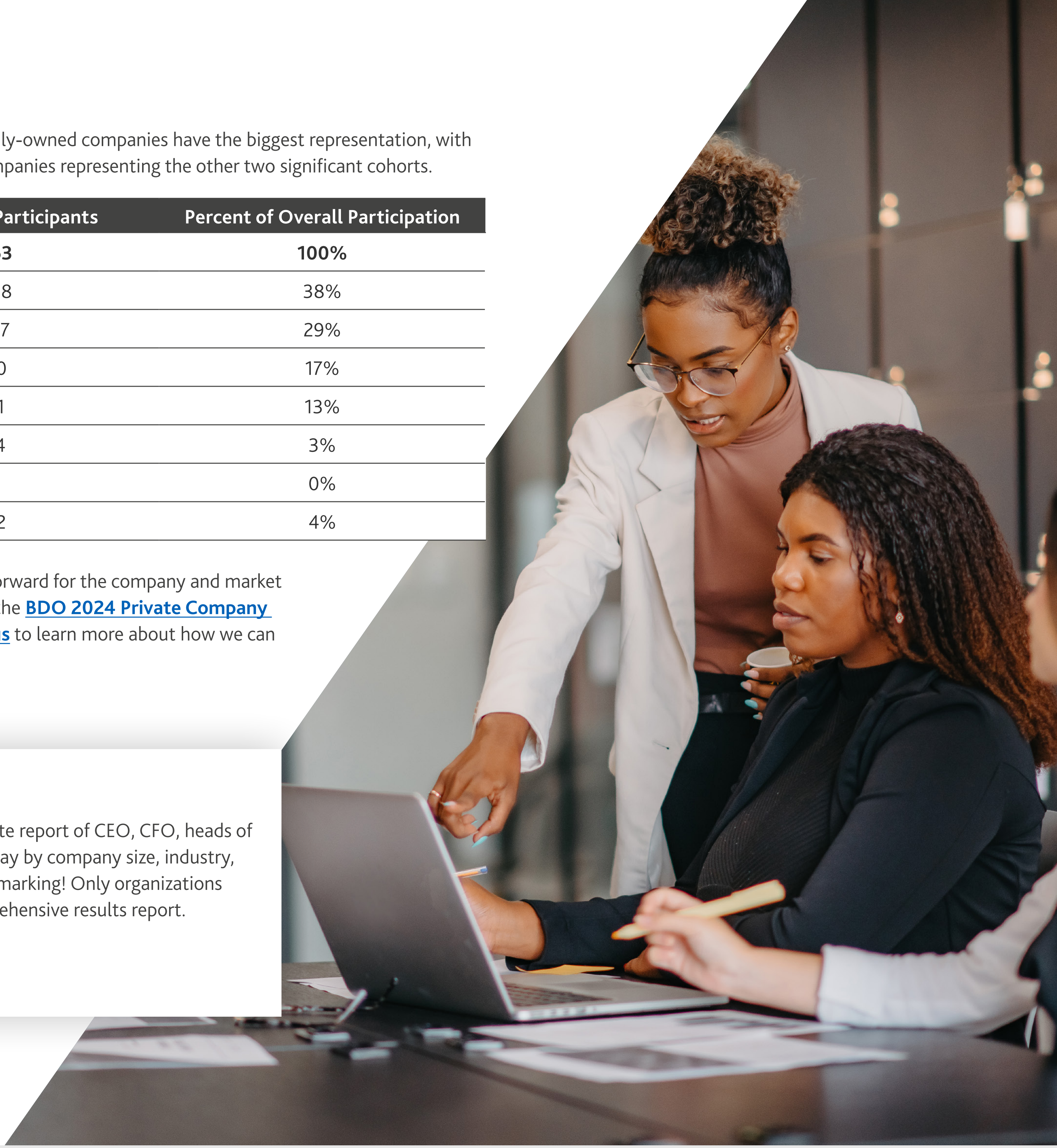
Asset Range	Number of Participants	Percentage of Overall Participation
Under $100M	14	2%
$100M-$500M	15	3%
$500M-$1.25B	12	2%
$1.25B-$2.5B	3	1%
$2.5B-$6B	6	1%
Over $6B	4	1%

Ownership

Of the private companies that participated in the survey, family-owned companies have the biggest representation, with other private and employee stock ownership plan (ESOP) companies representing the other two significant cohorts.

Majority Ownership	Number of Participants	Percent of Overall Participation
All Private	**563**	**100%**
Family Owned	208	38%
Other Private	157	29%
Employee Owned (ESOP)	90	17%
Private Equity	71	13%
Venture Capital	14	3%
Mutual	1	0%
Not Disclosed	22	4%

Developing a competitive pay package requires a clear path forward for the company and market information that allows for data-driven decisions. Download the BDO 2024 Private Company Executive Compensation Survey infographic and contact us to learn more about how we can help with compensation design and workforce strategy.



Participate in BDO's 2025 Survey

By participating, you will be eligible to receive our complete report of CEO, CFO, heads of operations (COOs), and top sales/marketing executives' pay by company size, industry, and ownership — a valuable tool for compensation benchmarking! Only organizations that complete the survey are eligible to receive the comprehensive results report.

TAKE THE SURVEY ▶

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