Compensation in Growth Environments: Avoiding Compensation Pitfalls While Scaling Your Privately Owned Business

COMPENSATION AT PRIVATE COMPANIES DEMYSTIFIED

DECEMBER 4, 2024

Agenda

- Compensation Challenges Facing Private Companies
- Executive Compensation: Key Drivers and Pitfalls to Avoid
- Broad Based Compensation: Key Drivers and Pitfalls to Avoid
- Sources of Guidance

With You Today

JASON BROOKS

Practice Leader Compensation
Consulting
Managing Director
BDO USA

jbrooks@bdo.com

JUDY CANAVAN

Compensation & Benefits
Survey Business
Managing Director
BDO USA

jcanavan@bdo.com

KATHRYN RADLE MOORS

Compensation
Consulting
Manager
BDO USA

kradlemoors@bdo.com

Challenges

In an effort to develop a functional compensation system, private companies often run into several challenges:

1. **Lack of Quality Data:** Private companies often struggle to find reliable – and appropriate - compensation benchmarks
2. **Unique Ownership Structures:** Variations include founder-owned, family-owned, employee-owned, and investor-owned companies, each with distinct needs
3. **Governance Structures:** Many private companies have evolving governance frameworks that may not fully support compensation decisions
4. **Stakeholder Savvy:** Stakeholders may lack the specialized experience needed to understand and support compensation strategies
5. **Time:** time is a precious commodity, especially early in a company's maturity curve – typically it is all hands-on deck launching, growing and ensuring the continued success of the company

Leaders want to know how to best navigate these challenges

Understand the Components of Compensation

- Compensation is a management tool – it is used to hire and retain as well direct and reward the actions of employees
- There are multiple components that serve these functions

Component	Description	Primary Function
Base Salary	The annual salary	• Attract and retain • Salary increases can be used to motivate and reward
Short Term Incentives (STI)	Payments made based on a performance period of one year or less	• Motivate and reward
Long-Term Incentives (LTI)	May include cash plans (with a performance period longer than one year), synthetic stock plans such as options, full-value stock awards, and any other LTIs	• Motivate, reward and retain
Benefits	Medical, life and other insurance products, paid time off, retirement, etc.	• Attract and retain
Other Compensation Arrangements	These may include deferred compensation arrangements and capital accumulation plans	• Retain

Obtain and Interpret Market Pay Levels

DATA

- **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 lack of readily available data for other private companies.*

INTERPRETATION

- **Considerations:** Organizational size, industry, and ownership structure

APPLICATION

- **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.

Compensation package design is nuanced. By and large, "best practices" may serve to guide but not dictate the design.

Executive Compensation

Key Drivers and Pitfalls to Avoid

QUESTION #1

What is your primary executive compensation concern?

- **A** Attracting Executive Talent
- **B** Retaining Executive Talent
- **C** Short-Term Incentive Design
- **D** Long-Term Incentive Design
- **E** Other

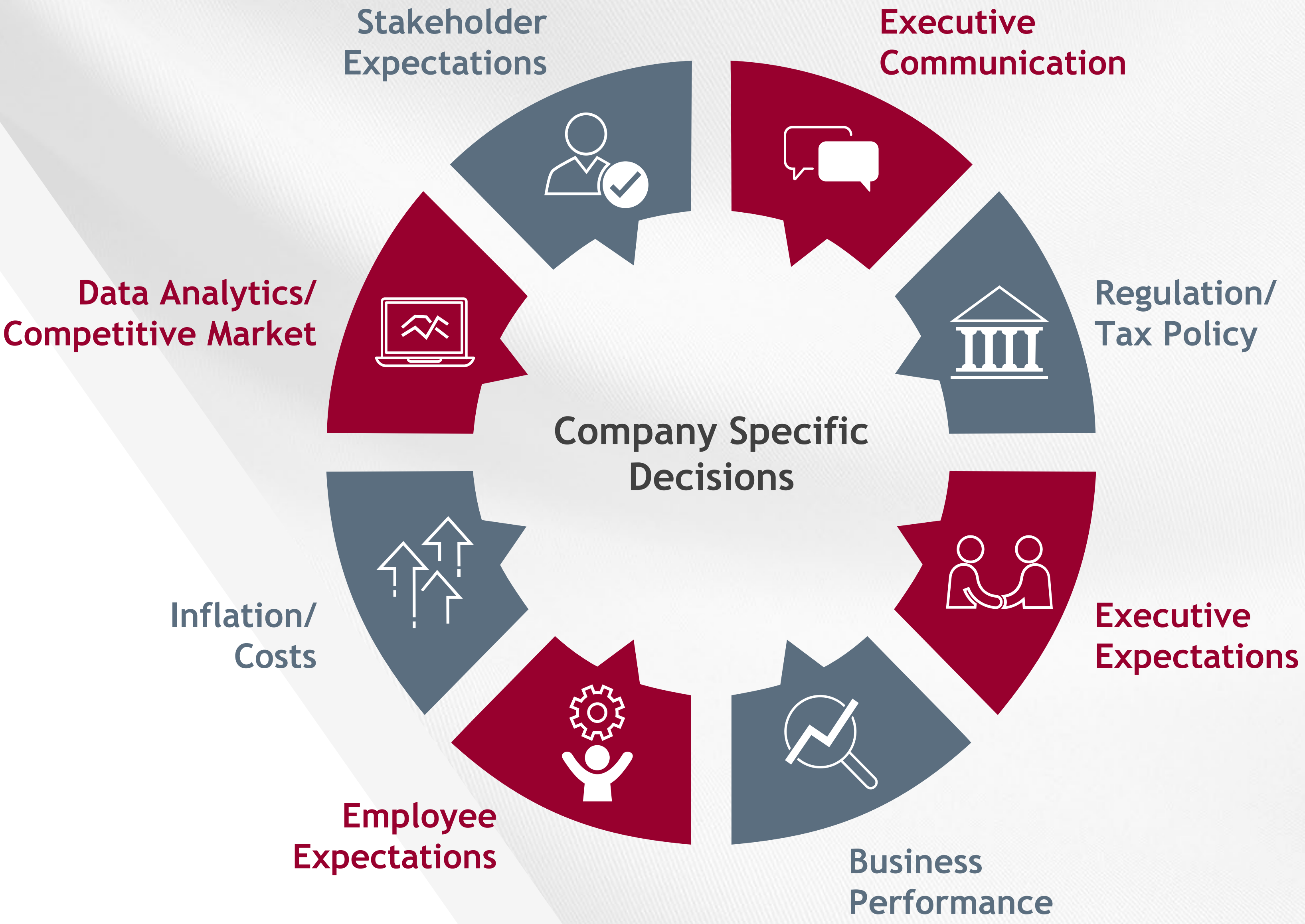
Executive Compensation Considerations

Internal Factors

- Business strategy
- Talent strategy
- Compensation philosophy
- Location

External Factors

- Government regulation
- Interest Rates
- Foreign exchange rates
- Stakeholders

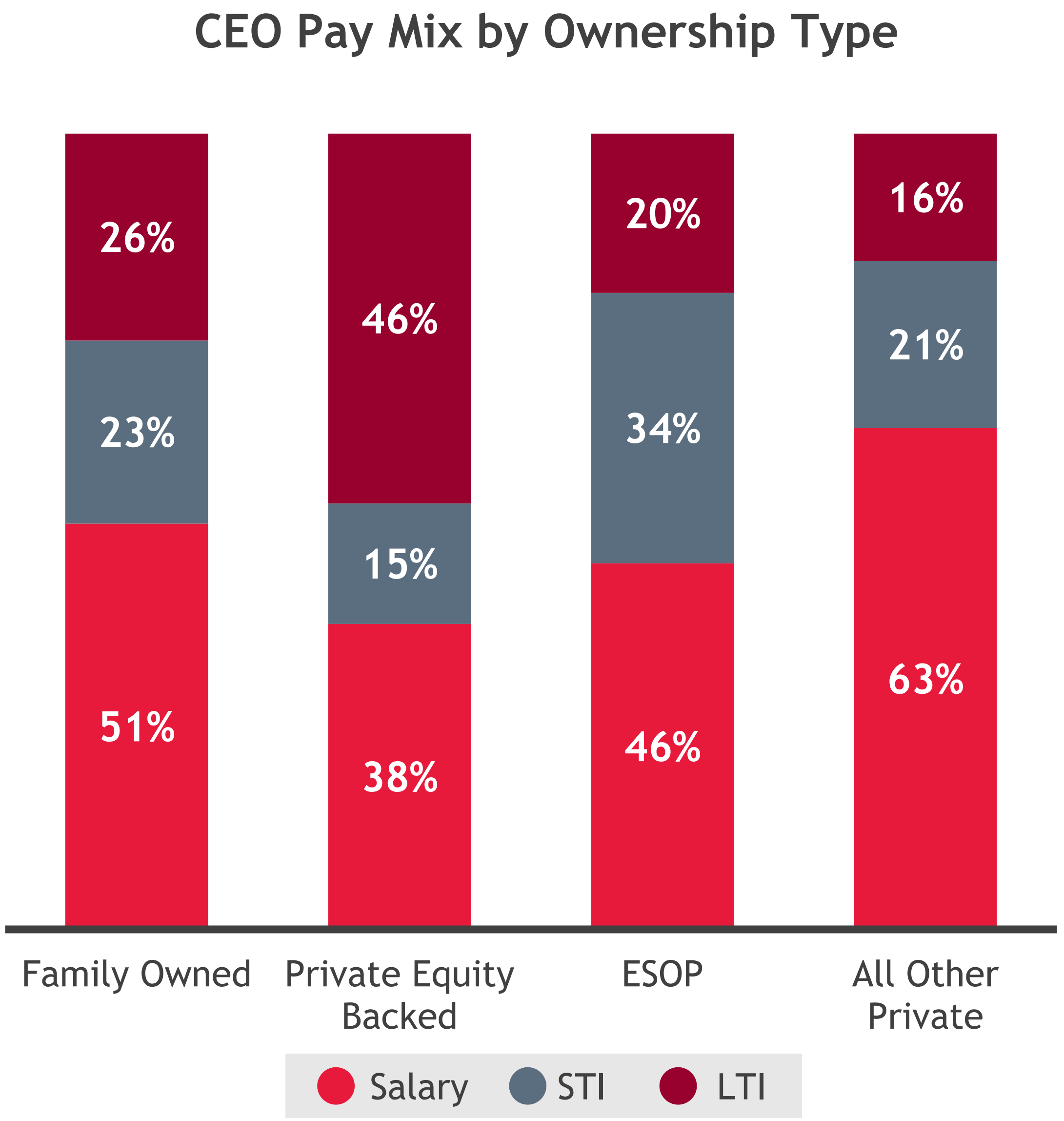


Examples of Factors Impacting Pay Levels and Delivery Follow

Ownership's Influence on Compensation

The use of compensation elements is strongly impacted by company ownership structure

- Pay mix is the percent of pay that is: Salary | Short-term incentive | Long-term incentive
- Among companies with $100 million to $500 million in revenue:
  - Family-owned companies favor salary, while private equity backed companies favor LTIs
  - Private, non-family-owned companies weigh most strongly to salary

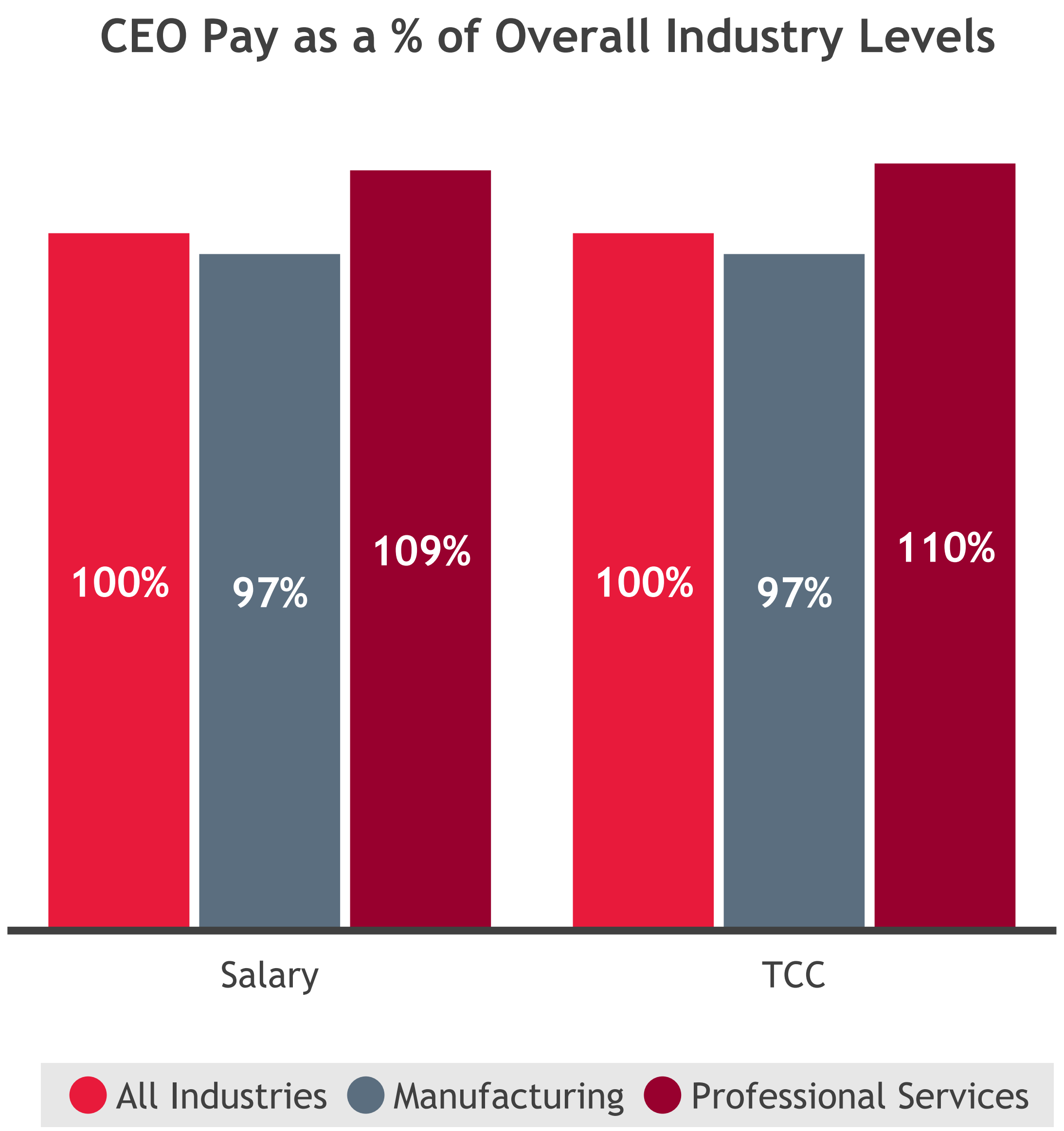


Industry Impact on Compensation

PROFESSIONAL SERVICES VS. MANUFACTURING

Industry is a key driver of compensation

- Pay differentials for professional services and manufacturing are highlighted at right
- Among companies with $100 million to $500 million in revenue:
  - CEOs in Manufacturing are compensated less on a cash (salary and bonus) basis than the median CEOs across industries
  - CEOs in Professional Services are compensated more than the median CEOs across industries



Tools to Avoid 5 Compensation Plan Design Pitfalls

1. **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.
2. **Proactive Transition Planning:** Invest in educating future leaders early. Don't wait until transitions become urgent; proactive education ensures smoother leadership changes and continuity.
3. **Regulatory Compliance:** Ensure all plans comply with regulations like Internal Revenue Code Section 409A. Engage a specialized attorney to review your plans, as demonstrated experience in this area is crucial to avoid legal issues.
4. **Strategic Decision-Making:** Base compensation decisions on data and strategic goals, not arbitrary methods. This helps to ensure alignment with company objectives and fairness.
5. **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.

Aligning Interests Without Ownership Transfer

CASE STUDY

CHALLENGE

A mid-sized manufacturing company is 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 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 ensuring sufficient funds 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.

RESULT

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

Broad Based Compensation

Key Drivers and Pitfalls to Avoid

QUESTION #2

What is your primary broad-based compensation concern?

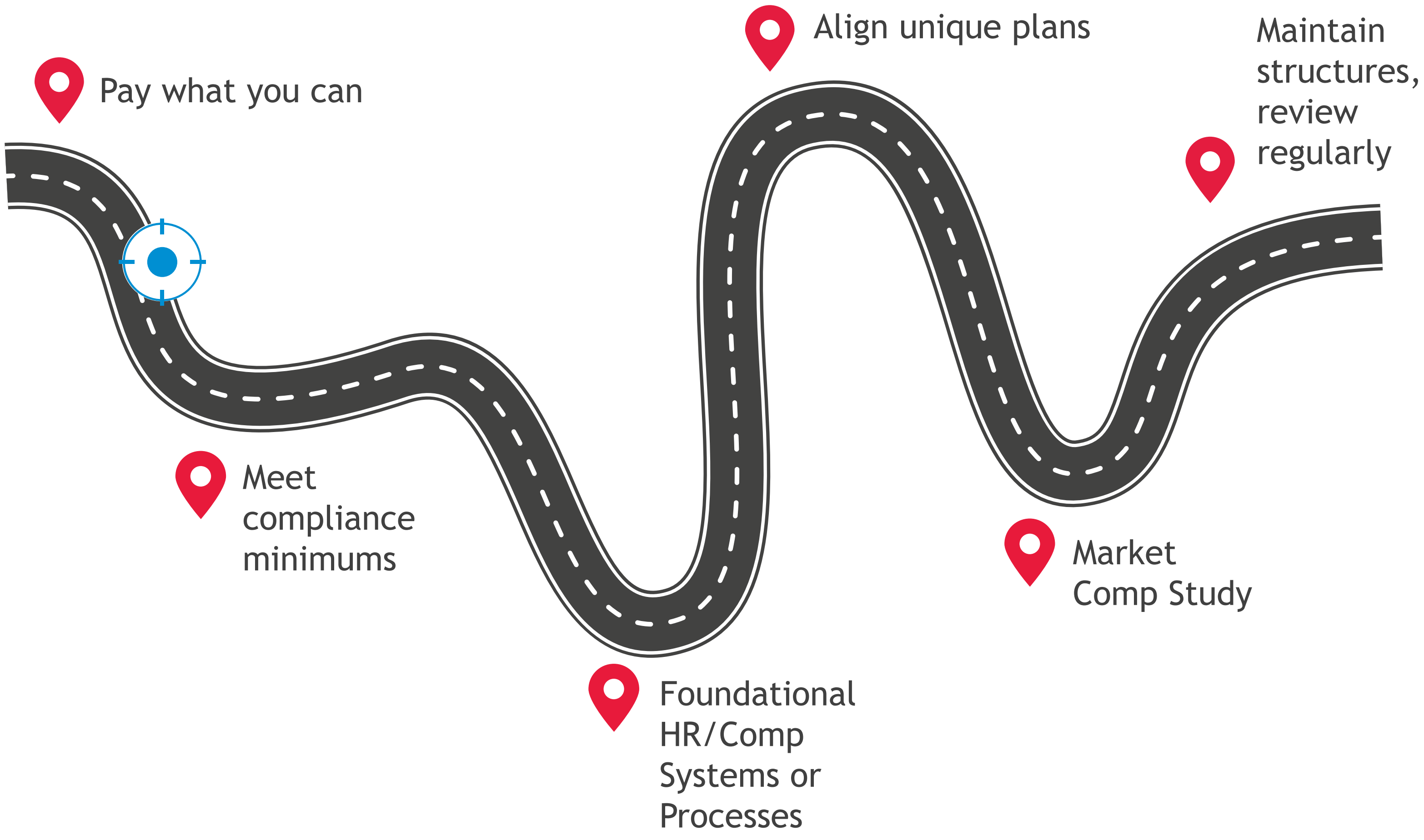
- **A** Paying Competitively
- **B** Determining ‘Market’
- **C** Developing Pay Structure
- **D** Aligning Pay and Performance
- **E** Other

Why is management of broad-based compensation so important?

- Ensure compensation dollars are spent as productively as possible (get the most bang for the buck)
- Leverage compensation as a management and performance tool
- Galvanize team towards shared goals, furthering the company's strategy
- Minimize time and money spent on avoidable compliance issues
- Minimize preventable and regrettable turnover

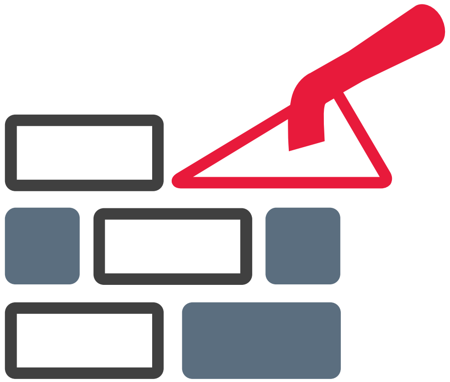
Growing a Company

COMPENSATION



Roadmap for compensation considerations

Although the steps may occur in a different order, the roadmap outlines a path to building your company's compensation muscle – whether it is through developing a robust Human Resources department, the finance team, or outsourcing.



Lay the groundwork needed to have success with compensation

1. Be compliant – outsource, reduce your risk
2. Align/normalize multiple employee-specific unique compensation plans
3. Make some upfront investments in HR team members / systems as needed

Keep an eye to the future when developing compensation

1. Be purposeful with compensation studies and intentional about implementation
2. Have a strategic mindset when developing pay structures and processes
3. Consider efficiencies with current compensation / Human Resources work

Compensation Groundwork

Compensation Groundwork

Compensation Groundwork

Eye to the Future

Flat and Nimble but not Without Unintended Consequences

CASE STUDY

CHALLENGE

A private manufacturing company is run by the father with his son poised to take the helm. Great immigrant success story. However, they struggle to (1) attract employees to their manufacturing site, and (2) motivate employees to take on more responsibility. Pay levels were determined by hearsay rather than data.

APPROACH

A consultant was retained to help identify the root cause of the challenge and develop a solution. It was found that manufacturing roles were not clearly defined, pay was tenured-based rather than skills-based and there was no alignment of the pay for a role with market rates of pay.

Job families were defined (e.g., production, tooling, stockroom, quality control), career levels were defined along with skill and certification requirements. Market pay rates were determined and a salary structure was developed.

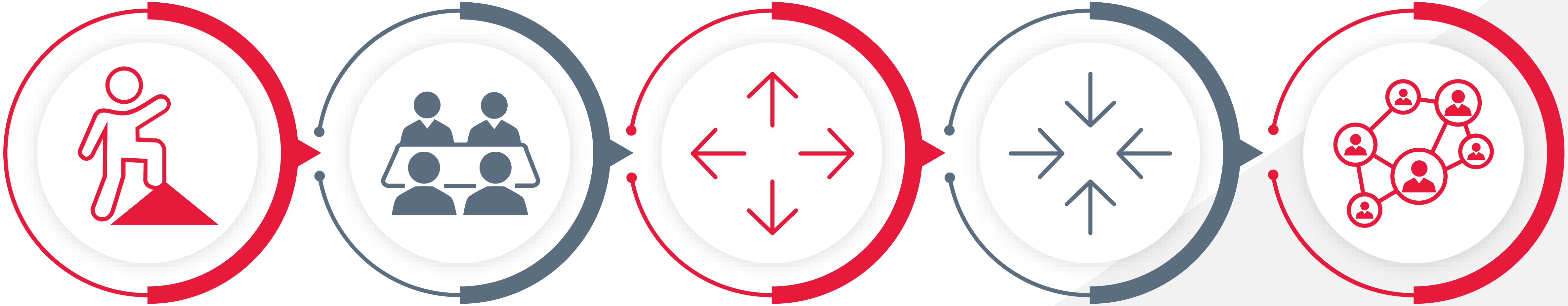
RESULT

The client could now fill the more demanding QC roles because pay was aligned with the market; employees were more motivated to study for certifications as it offered an opportunity for promotion, and career opportunity became a selling point for hiring.

Sources of Guidance

When and Where to Turn for Guidance and Advice

To ensure success, savvy leaders reach out to colleagues, board members and consultants for guidance and experience.



CEO	**Executive Team**	**External Support**	**Internal Support**	**Other**
Personal Experience	Strengthen Core Team	Colleagues and Consultants	Fiduciary and/or Advisory Board	Varies by Need

When to Install a Board

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

- About 70% of the companies have a board of some type
- Fiduciary boards are significantly more common than advisory boards (about double the percent of companies)
  - 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 earlier generations tend to hover at or below 40%
- PE/VC backed firms are highly likely to have a board (67%), second only to ESOPs (82%) which by their nature are typically required to have a board

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