

BayBio 2008

Equity Compensation Strategy Development: Roadmap from pre-IPO to Publicly-Traded

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Today's discussion

- ▶ Key equity challenges for pre-IPO companies
 - Addressing employee dilution and communicating value
 - Refresher grants for “unglued” employees
 - Managing a proper pool size
 - Preparing for an ESPP

- ▶ Key equity challenges for public companies
 - Taking a close look at equity (one size doesn't fit all)
 - Establishing grant guidelines
 - Shareholder requests (planning for “No” and getting a “Yes” from ISS)
 - Going international

- ▶ Questions & Answers

Pre-IPO Equity Challenges

Pre-IPO Equity Challenges

Addressing employee dilution and communicating value

Considerations

- ▶ Do employees understand how their grants are effected?
- ▶ Should certain employees or executives be kept “whole”?
- ▶ What are employee’s expectations upon hire?
- ▶ How long before the IPO occurs?
- ▶ How are grants communicated to employees in offer letter and post-hire?

Action Steps

- ▶ Analyze impact of dilution on employee population
- ▶ Develop communication to equity grant participants
- ▶ Adjust new hire grant guidelines post-round
- ▶ For executives, there is keen eye on % of company held – understand if the current levels appropriate
- ▶ For broad-based employees, communicate how to calculate potential gain, using their own assumptions

Market Norms & Tools

- ▶ After each round of financing, typical for new hire grant guidelines to adjust downward
- ▶ Reflects risk-reward relationship of those joining early (more risk) vs. those joining closer to IPO (less risk)
- ▶ Typical adjustment is 10-25% per round
- ▶ Use examples of potential gain/losses in employee communications

Pre-IPO Equity Challenges

Refresher grants for “unglued” employees

Considerations

- ▶ How vested are employees currently?
- ▶ Is there a large percent of key contributors and executives with a high level of vested shares?
- ▶ What is the timeline for the IPO?
- ▶ Are shares available for a refresher?

Action Steps

- ▶ Monitor amount of “glue” on employee population
- ▶ Agree on desired level of vested shares (e.g., bring employees to no more than 50% vested position)
- ▶ Understand impact on equity pool
- ▶ Plan for “overages”

Market Norms & Tools

- ▶ Typical refresher grant is less than 50% of new hire grant
- ▶ Most likely in the 20-30% range
- ▶ Stock options are the typical equity vehicle
- ▶ Vesting provisions are usually similar

Pre-IPO Equity Challenges

Managing a proper pool size

Considerations

- ▶ How big is the pool?
- ▶ What factors were used in determining the size of the pool?
- ▶ Are large numbers of shares needed for future new hires?
- ▶ What is the timeline for the IPO?
- ▶ How competitive have grants been in the past?

Action Steps

- ▶ Estimate future share requirements from a bottoms-up perspective
- ▶ Create visibility in estimates with the Board
- ▶ Be realistic in estimations
- ▶ Plan for overages
- ▶ Be aggressive in IPO plan pool request

Market Norms & Tools

- ▶ Typical pools are in the 15-20% range
- ▶ Executive hires will “chew up” pool, particularly in a replacement scenario
- ▶ Budgeting factors:
 - ▶ New hire grants
 - ▶ Replacement hires
 - ▶ Refresher grants
 - ▶ “Top-off” grants
 - ▶ Special award pool

Pre-IPO Equity Challenges

Preparing for an Employee Stock Purchase Plan (ESPP)

Considerations

- ▶ As the IPO approaches, planning should begin
- ▶ What are other peer companies doing?
- ▶ What discount will be offered?
- ▶ Will there be a look-back period and if so, how long?
- ▶ How many shares need to be reserved?
- ▶ Will there be an evergreen provision?

Action Steps

- ▶ Analyze competitive market practices using post-IPO peers
- ▶ Develop proposed term sheet, including key features
- ▶ Understand financial accounting impact - compare against other awards
- ▶ Discuss value of program to broad-based employee population
- ▶ Calculate anticipated usage

Market Norms & Tools

- ▶ Prevalence is high for recently public companies
- ▶ Recent IPOs still offer a 15% discount
- ▶ Recent IPOs are using a look-back period ranging from 6-24 months
- ▶ Typical to use 7-10% of covered pay (Evergreen provisions can range up to 5% of common shares)

Public Equity Challenges

Public Equity Challenges

Taking a close look at equity (one size doesn't fit all)

Considerations

- ▶ What is the role of equity going forward?
- ▶ How will grant values be positioned relative to the market?
- ▶ What equity vehicle(s) make sense?
- ▶ What is the level of participation going forward?
- ▶ How will grants be linked to performance?
- ▶ What can the organization afford?

Action Steps

- ▶ Agree on equity compensation philosophy
- ▶ Determine several design characteristics:
 - Frequency of grants
 - Eligibility & participation
 - Equity type
 - Vesting provisions
 - Projected usage & cost

Market Norms & Tools

- ▶ Most companies have both new hire and ongoing grant practices, about 2/3 have stated grant guidelines
- ▶ Eligibility tend to be greater than 80% of employees with participation above 60% of employees
- ▶ Stock options tend to be the primary equity vehicle for broad-based population (RS on the rise)
- ▶ Aggregate usage levels are shrinking, even for recent IPOs

Public Equity Challenges

Establishing grant guidelines

Considerations

- ▶ How often will the grants be made?
- ▶ Who will be eligible?
- ▶ What is the relative size of the grants vs. the new hire grant?
- ▶ How will the grant size be communicated?
- ▶ How will the grants be linked to performance?

Action Steps

- ▶ Agree on equity compensation philosophy
- ▶ Determine grant guidelines, based on market values
- ▶ Link size of ongoing grant guidelines to new hire grant guidelines to ensure consistency
- ▶ Link performance ratings to guideline range to drive performance aspect of grants

Market Norms & Tools

- ▶ Most companies provide ongoing grants on an annual basis
- ▶ Employees become eligible after 3 months of employment
- ▶ Grant size can be linked to performance ratings
- ▶ Ongoing grants tend to 50-66% of the size of new hire grants
- ▶ Vesting ranges from 3-4 years, with a one year cliff

Public Equity Challenges

Shareholder requests (planning for “No” and getting a “Yes” for ISS)

Considerations

- ▶ Do we need ISS support?
- ▶ Are other ISS policies/overrides at play?
 - Burn rate
 - Pay for performance
 - Repricing
- ▶ Can the company “sell” its requested share increase to its shareholders (with or without ISS support?)

Action Steps

- ▶ Evaluate whether shareholders follow ISS recommendations
- ▶ Determine whether shareholders have own voting guidelines
- ▶ Evaluate overrides and determine whether corrective measures are acceptable
- ▶ Consider engaging proxy solicitor

Market Norms & Tools

- ▶ Range of “shareholder value transfer” cost is from 5-20% (very difficult to reverse engineer)
- ▶ Burn rate chart and calculators available
- ▶ Yahoo! Finance to determine pay for performance

Public Equity Challenges

Going international

Considerations

- ▶ Consistency of equity compensation philosophy
- ▶ Local competitive practices and norms
- ▶ Local laws and tax consequences of grant practices
- ▶ Communication gap
- ▶ Ability to manage a global strategy

Action Steps

- ▶ Review local norms & laws relative to domestic grant strategy
- ▶ Agree on variance to domestic strategy by location
- ▶ Assess foreign laws (including tax-favored and disfavored equity awards)

Market Norms & Tools

- ▶ Lower expectations by employees in certain foreign countries

Questions and answers

What are your questions?

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