Educating and Inspiring the World at Work
JUNE/JULY 2020
WORKSPAN

NOT JUST ANOTHER COMPENSATION STORY

HOW PRIVATELY HELD AND NONPROFIT ORGANIZATIONS CREATE COMPELLING EXECUTIVE PAY PROGRAMS

BY BONNIE SCHINDLER

PHOTO © ISTOCK/JOHNNYGREIG

One of the surest signs of spring — perhaps more so in our variable-weather world than flowers budding and geese flying north — is the onslaught of news stories about executive pay packages. Each spring, public companies release compensation data for the top five named executive officers, and the news stories quickly follow. *Who is the highest paid CEO? Is pay really linked with company performance? Whose equity grants are worth the most?* While public companies occupy the limelight and set the standard for what people think about executive pay, the number of United States-based public companies have declined to about 3,600. Private companies and nonprofits outnumber their publicly-traded peers, and offer compelling executive pay packages without fanfare and without publicly-traded stock. While the lack of publicly-traded stock creates challenges, particularly with regard to long-term incentives (LTIs), private companies and nonprofits can use a number of strategies to develop thoughtful and creative executive pay programs, and deliver competitive compensation.

Private Company and Nonprofit Pay Models

Executive compensation is composed of three main components: base salary, short-term or annual incentives and LTIs. The public company executive pay model is what most people are familiar with because of news stories and "Say-on-Pay" votes. Say-on-Pay and the large role played by proxy advisors has resulted in a "standardization" of public company pay where no one wants to stand out. This public company pay model emphasizes incentive-based pay, including annual incentives and long-term, equity incentives. In public companies, LTIs are the largest component of executive compensation. Public company pay positioning often targets the competitive median, with the company's stock price performance driving pay results.

In contrast, private companies and nonprofits focus on cash compensation, with private companies emphasizing base salary and annual incentives, and nonprofits emphasizing salary and benefits. As a result, cash pay positioning is often above median, with low or sometimes no LTI opportunity. However, the trend is to offer more incentive-based compensation, as noted by Compensation Advisory Partners (CAP) and WorldatWork's biannual surveys of incentive pay practices at private companies and nonprofit and government organizations. The data cited in this article are from the "2019 CAP-WorldatWork Incentive Pay Practices" surveys.

Since CAP and WorldatWork began surveying private companies and nonprofits more than a decade ago, annual and LTIs have grown in importance to these organizations. This same time period also saw sustained economic and stock-market growth.

Figure 1: Pay Models

Comparison of Private Company and Nonprofit Pay Models

Pay Component	Private Companies	Nonprofits
Base Salary	• Emphasized. • Typically one-third to one-half of executive compensation.	• Strongly emphasized and the largest component of executive compensation.
Short-Term/Annual Incentives	• Offered by nearly all private companies. • One to three performance measures are common. • Financial measures, such as profitability and revenue, are most common, but individual performance is also considered. • Maximum upside is 150% to 200% of target.	• Offered by three-quarters of nonprofits. • Performance measurement is holistic, with four to six measures being most common. • Typical measures are operational, such as customer-related (e.g., new customers, customer retention or customer satisfaction) and service/quality. • Maximum upside is 150% of target or less.
Long-Term Incentives (LTIs)	• Six out of 10 private companies offer LTIs. • The most common vehicle is a long-term, cash-based plan. • About one-third of private companies offering LTIs grant real equity (either restricted stock or stock options).	• Only two out of 10 nonprofits offer LTIs, such as a long-term cash plan or nonqualified deferred compensation.

Source: Compensation Advisory Partners

Private Companies

Nearly all private companies reported offering short-term incentives (STIs) in 2019. Most private companies tie executive STI payouts to a combination of financial and individual goals, with profitability being the most prevalent financial metric. Approximately six out of 10 private companies offer an LTI program, with three-year, cash-based performance awards being the most prevalent approach. Profitability metrics are also emphasized in LTIs. The target award values of private company LTIs are typically lower relative to public company peers. Private companies that do not offer LTIs typically offset the lack of these awards with more aggressive cash compensation positioning.

Nonprofits

Three-quarters of nonprofit organizations offer STIs, and only about two in 10 organizations report using LTIs, including cash-based performance awards and nonqualified deferred compensation. STIs for executives at nonprofits emphasize a mix of operational and individual measures to provide a holistic view of performance. Nonprofit STI target values are more modest relative to for-profit peers, but have grown in the past decade. Nonprofits typically emphasize base salaries in the overall executive compensation mix. In addition, health and welfare benefits often play a large role in the nonprofit employment value proposition (EVP). Besides incentives, nonprofit organizations cite that having a retirement plan is their most prevalent rewards tool for retaining talent.

Benchmarking

In addition to having different pay models from their public company peers, private companies and nonprofits have unique executive pay benchmarking considerations. Publicly-traded companies typically focus on the pay levels and practices of other similar public companies. Private companies and nonprofits need to carefully define their markets for talent before benchmarking executive compensation. An organization's market for executive talent should be defined to include frequent recruitment sources or market competitors. A large private company that competes with publicly-traded companies may include those firms in its market for talent. Similarly, many nonprofits hire from both the for-profit and nonprofit sectors. As a result, benchmarking data may be drawn from different sectors.

Nonprofits have an additional consideration when it comes to executive pay benchmarking: They are subject to Internal Revenue Service (IRS) rules intended to prohibit excessive executive compensation and abuse of tax-exempt status. Nonprofits can pay executives "fair and reasonable" compensation in order to retain their nonprofit, tax-exempt status. However, no standard benchmarking approach is defined to determine "fair and reasonable" compensation. Nonprofits need to

Figure 2
Survey Example: Chief Executive Officer Total Direct Compensation

Survey Response	Base Salary	Annual Incentive	Total Cash	Long-Term Incentive	Total Direct Compensation
Company 1	$350,000	$280,000	$630,000	$350,000	$980,000
Company 2	$375,000	$243,750	$618,750	$318,750	$937,500
Company 3: No LTI	$425,000	$425,000	$850,000	$0	$850,000
Company 4	$435,000	$217,500	$652,500	$108,750	$761,250
Average					
All Data Points	**$396,250**	**$291,563**	**$687,813**	**$194,375**	**$882,188**
Excludes Zero				***$259,167***	

Source: Compensation Advisory Partners

make sure that they benchmark executive compensation through an independent governance process that considers comparable organizations and a reasonable methodology. Nonprofits that are concerned about their executive compensation programs often proactively document their benchmarking methodology and rationale, or work with an outside advisor to do so.

Benchmarking executive pay can be challenging for private companies and nonprofits for more tactical reasons. Executive compensation data for peer companies is harder to find for both private companies and nonprofits. Private companies with publicly-traded peers often review their executive compensation data as reference points, but private companies without publicly-traded peers have to depend on survey data for executive benchmarking. For these private companies, the quality of the survey sources is paramount. Survey sources should be carefully reviewed to ensure the availability of appropriate data cuts based on industry and size, which is highly correlated with the level of executive pay. In addition, having multiple survey sources is valuable so that data can be corroborated, and the data sample is robust. Without using multiple survey sources, outlying data cannot be identified.

On the nonprofit side, peer company executive pay data are available through Form 990 filings with the IRS. However, the executive pay data is often dated by a couple of years because of timing of the Form 990 filings. As a result, the data must be carefully reviewed for executive changes and updated to the current time period using a reasonable assumption about pay increases (typically 2% to 3% per year, which are typical nonprofit salary increase levels on an annualized basis). WorldatWork's annual "Salary Budget Survey" is a good reference source for salary increase factors to apply to Form 990 and other survey data.

Private companies also need to consider carefully the LTI data from survey sources, if the sources report LTI data at all. Surveys typically look at compensation data by component and in total. When calculating the data for each component, some survey sources exclude the zeros to provide a better understanding of what the incentive amount is *if it is offered*. This can skew the component data, as Figure 2 illustrates.

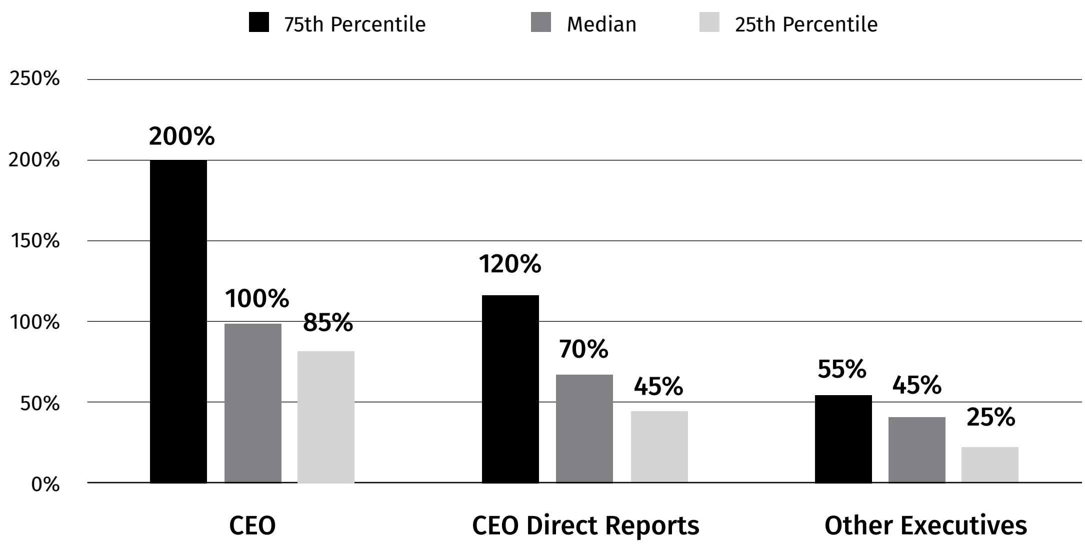
Private companies should pay close attention to the LTI data for executive positions, especially since each survey may use different LTI valuation assumptions. If the reported LTI survey values seem high, they should be reality-checked against the total direct compensation for the survey source and against the LTI data from other sources. High LTI data may result from the exclusion of zeros from the survey data, as in the example above, and from the inclusion of public company data with higher LTI values. The list of survey respondents

BENCHMARKING EXAMPLES

Private company example: A privately held financial services company with almost $1 billion in revenue recruits executive talent from both publicly-traded and privately-held firms, and its management team closely follows the performance of and executive compensation at publicly-traded peer companies. As a result, the company decides to have a publicly-traded peer group to supplement survey data for its annual executive compensation benchmarking exercise. The data are weighted more heavily in compensation analyses, and public company LTI data are discounted to reflect the lack of liquidity in a private company situation.

Nonprofit example: A large, prominent health-care nonprofit regularly competes with for-profit companies for talent across all employee groups. As a result, the nonprofit decides to consider both nonprofit and for-profit compensation sources for its executive and broader employee benchmarking analyses. The health-care nonprofit decides to review the nonprofit and for-profit data separately, versus averaging the data, for each executive position. That approach avoids skewing the data on the high side and provides greater flexibility in decision-making, as different pay components can be selected.

Figure 3
Private Company LTI Award Opportunities *(As a % of Base Salary)*



Source: WorldatWork/Compensation Advisory Partners

provides perspective on the composition of participants and could indicate the amount of public company data included.

Several approaches can be used to adjust biased LTI values. The LTI data can be discounted, or calculated using total direct compensation (TDC) less total annual compensation (TAC). If LTI levels are unrealistic or not reported in the survey, more reliable data can be substituted. If another source is needed to check the data, the CAP-WorldatWork data can be used as a corroborating source. The survey collected the expected value of LTI grants as a percentage of base salary for the following executive groups. (See Figure 3.)

LTI Plan Design and Communication

LTIs are the most challenging component of executive compensation for private companies and are used by only a small portion of nonprofits. Private companies offer LTIs primarily as an executive retention vehicle, but other goals are to align executives' incentives with the owners' long-term goals and to compete for talent with other employers.

When private companies are designing LTI programs, the first step is to understand the owners' willingness to share value in the form of an economic interest or real equity with executives. For private companies that offer LTIs, a typical sharing percentage ranges from 5% to 10%. The next step is to select an LTI vehicle. Long-term cash plans are favored by companies operating as going concerns or those in the midst of a turnaround; real equity is favored by start-ups and high-growth companies, private equity-owned firms, and those moving toward a value-realizing event, such as a sale or initial public offering; and phantom equity is often used by companies that may have a value-realizing event in the future, or that may wish to transfer ownership for succession-planning purposes. (See Figure 4.)

The final design step is a clear communication plan. If LTIs are not well-communicated to executives, they can undervalue the incentives. This creates an unfortunate situation where a private company's owners have invested time and money in providing executives with a competitive LTI opportunity, but the executives do not value the LTI as highly as the company's owners intended. Since LTIs at private companies are most often reserved for executives, a focused communication plan is advised. The communication plan should include both in-person meetings and written plan documentation, and periodic updates on company performance. In addition, CAP has found that executives greatly appreciate interactive LTI calculators, which can be as simple as an Excel model or can be a more elaborate web-based tool. The calculator allows executives to model their LTI payouts under different performance scenarios and understand their wealth-accumulation opportunities. (See Figure 5.) Since the timing of taxes is often a major issue for LTIs, some calculators allow executives to model their potential tax liabilities as well.

Nonprofit organizations also benefit greatly from clear and comprehensive communication of their executive

Figure 4
Private Company Long-Term Incentives

	Real Equity	Phantom Equity	Long-Term Cash
Common Vehicles	• Restricted stock • Performance share • Stock option • Profit interests for limited liability companies (LLCs) - typically pre-IPO and private-equity backed	• Phantom stock • Stock appreciation right (SAR) (a phantom stock option)	• Long-term cash plan (multiyear bonus) • Performance unit (dollar-denominated units awarded based on performance)
Company Business Structure	• C-Corp • S-Corp (with limitations) • LLCs (with limitations)	• Any	• Any
Key Requirements	• Owners willing to share equity	• Comfort with plan complexity • Strong communications support	• Solid financial budgeting, forecasting • Transparency of key financials
Company Situation			
• Start-up/high growth	●	○	○
• Moving toward value-realizing event	●	◑	○
• Private-equity ownership	●	○	○
• Turnaround	◑	◑	●
• Succession planning	●	◑	○
• Business as usual	◑	◑	◑

● Pro/most useful
◑ Neutral/somewhat useful
○ Con/least useful

Source: Compensation Advisory Partners

Figure 5
XYZ Corp. Phantom Stock Plan Calculator

This calculator is for illustrative purposes only.

Name	Joanne Smith
Position	Vice President
Target Grant Value	$100,000
Current Stock Value	$100
Units Granted	1,000

Assumptions	
Unit Growth	8%
Dividend Yield	5%
	^Input^

	Grant	2021	2022	2023	2024	2025
Units						
Unvested	1,000	800	600	400	200	0
Vested	0	200	400	600	800	1,000
Value						
Unit Value	$100	$108	$117	$126	$136	$147
Vested Value	$0	$21,600	$46,656	$75,583	$108,839	$146,933
Dividends on Vested Units						
Annual	$0	$1,080	$2,333	$3,779	$5,442	$7,347
Cumulative	$0	$1,080	$3,413	$7,192	$12,634	$19,981
Payout in Year 5 (Vested Value + Cumulative Dividends)						**$166,914**

Source: Compensation Advisory Partners

pay programs and other workplace rewards. Nonprofits typically offer a more holistic compensation and rewards program that includes an emphasis on base salary, an annual incentive opportunity with a lower target value relative to for-profit organizations, generous health and welfare benefits, and defined contribution retirement plans. Nonprofits may offer nonqualified deferred compensation for executives as a long-term wealth-accumulation opportunity. Nonprofit employment also offers executives satisfaction in advancing a worthy cause and other non-compensatory rewards, such as work flexibility, training opportunities, job rotations that expand skills, and a positive workplace culture. Nonprofits can benefit greatly by communicating these compensatory and non-compensatory rewards to executives and employees so that the rewards are understood and appropriately valued. Nonprofits also should celebrate and communicate individual and organizational successes and take the time to recognize a job well done. Such communication can reinforce the intangible benefits of nonprofit employment.

Private companies and nonprofits face unique challenges when it comes to executive compensation because benchmarking data are less available, and these organizations lack publicly-traded stock. However, private companies and nonprofits can offer compelling executive compensation packages with extra work, thought and creativity. Private companies and nonprofits need to communicate their unique value propositions to executives and also should remind their executives of a huge selling point relative to publicly-traded peers: Their compensation programs are far less likely to end up as an embarrassing news story. **ws**

Bonnie Schindler is a principal at Compensation Advisory Partners. She can be reached at *Bonnie.Schindler@capartners.com*.