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Incentive Pay Practices
at Private Companies

A study shows private companies working harder to attract talent.

Private companies in the United States have stepped up their game in the competition for talent. The majority of private companies now offer long-term incentives (LTIs) in addition to short-term incentives (STIs), according to a new study on incentive-pay practices at private companies by WorldatWork and Vivient Consulting. The "Private Company Incentive Pay Practices Survey," released in February 2012, found that having an LTI plan is now the prevalent practice across all types of private, for-profit companies, except partnerships.

The study found that LTI use at private companies increased to 61 percent in 2011, up from 35 percent in 2007, when the study was previously conducted. Survey respondents also report increased use of STI programs, such as bonus plans. STI plan prevalence at private companies grew to 95 percent in 2011 from 79 percent in the 2007 study.

The latest study findings are striking because private companies face unique incentive-compensation hurdles relative to their public peers, particularly when it comes to providing LTIs. Private companies lack publicly traded equity, so providing competitive LTIs can be difficult in terms of valuation, liquidity and ownership structure. In addition, private companies are not subject to the same financial and compensation disclosure rules as public companies. This makes competitive data scarce, benchmarking incentives and performance against peers difficult.

By Bonnie Schindler, Vivient Consulting

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This article provides an overview of the new survey results and compares the 2011 findings with those from 2007. The survey, which was sent to a sample of WorldatWork members, drew responses from 230 for-profit, private companies with revenues ranging from $100 million to more than $5 billion. Industries represented include manufacturing; financial services and insurance; business and professional services; retail and wholesale trade; utilities, oil and gas; computers and electronics; health care and social assistance; and information services. The corporate status of responding organizations was primarily C Corp. (30 percent), LLC (28 percent), subsidiaries (23 percent), S Corp. (12 percent) and partnerships (7 percent). The survey also drew responses from 90 nonprofit and government organizations. The results for these organizations have been reported separately.

Long-Term Incentives

Unlike publicly traded companies that rely heavily on restricted stock and stock options, private companies prefer LTI plans that pay out in cash, such as performance awards — essentially a long-term bonus plan — and phantom stock/stock appreciation rights (SARs). For private companies, cash-denominated plans are simpler to design and operate, and avoid the costs and complexities associated with plans that rely on real equity.

Not surprisingly, private company LTI awards continue to be focused on the CEO and top executives, with minimal usage at the management and exempt professional levels.

Of the respondents reporting that their private companies offer LTI plans, half now use performance awards. The prevalence of performance awards is up from one-third in 2007. Phantom stock and SARs are used by about one-third of private companies with LTI plans, also up from 2007. Stock-option usage has dropped to one-quarter of private companies with LTI plans, while restricted stock continues to be used to a lesser degree. (See Figure 1.)

Companies that report using performance awards typically have three-year performance periods, and pay out awards in cash. Awards are most heavily based on overall corporate performance, with operating income being the most prevalent performance measure.

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As in 2007, nearly three out of four respondents say that their companies have only one LTI plan in place, reflecting the cost and complexity of designing such a plan.

The top three objectives of LTI plans at private companies remain the same as in 2007:

- Align employees' incentives with long-term goals (63 percent)
- Retain employees (60 percent)
- Be competitive with other employers (45 percent).

While the top three objectives remain the same overall, "aligning employees' incentives with long-term goals" moved into the top spot, replacing "retaining employees."

One in 10 respondents said that their companies would add or modify an LTI plan in 2012. The most commonly cited reason to change or modify an LTI plan is if the company changes its strategy.

Respondents were asked whether the recent recession prompted any changes to LTI programs. Only one in four companies reported changes to an LTI plan because of the difficult economy.

The private companies surveyed report modest equity overhang, which is equity outstanding and equity available for current and future grants. Seven out of 10 respondents with LTI plans in place report equity pools of about 10 percent or less. This reflects the fact that many private companies do not use real equity for LTI grants, and those that do focus LTI programs on a select group of participants. (See Figure 2.)

For private companies in the survey that use real equity, median overall employee ownership is 11.5 percent in 2011, up slightly from 10 percent in 2007.

At private companies, equity valuation is a key consideration for any LTI plan that relies on the value of real equity. Despite its cost, outside appraisal of equity value is the preferred valuation mechanism for stock options and restricted stock. In contrast, phantom stock and stock appreciation rights are more likely to rely on a formula-based valuation. (See Figure 3.)

Another key issue for the minority of private companies using real equity is how liquidity is provided for stock option and restricted stock grants. According to survey respondents, liquidity is provided for stock options most commonly at a value-realizing event, such as a sale of the company or an initial public offering.

More than half of the respondents provide liquidity for restricted stock grants at employee termination if certain criteria are met, while this is less common for stock options. For stock options, a minority of respondents report that their companies offer periodic trading sessions where employees can exercise options and/or sell the underlying equity. This practice is used more commonly for restricted stock. (See Figure 4.)

Survey participants were also asked about deferred compensation. Of the survey respondents, 35 percent report that their companies offer deferred compensation plans for highly compensated individuals, generally the CEO and executives. This is down from 43 percent in 2007. At private companies offering deferred compensation plans, contributions are typically made by either the employee only or by both the employer and employee. Most firms do not provide an employer match for participants.

Short-Term Incentives

Of the respondents indicating that their private companies have an STI plan, nearly four out of 10 have one plan, while the rest have two or more STI plans in place. Nearly one-third of the respondents say that their companies are planning to add or modify a short-term incentive plan in 2012. The most common reasons to add or modify an STI plan are a change in strategy (50 percent), improving business results (36 percent) and a new management team (23 percent).

Survey participants were asked what impact the recent economy had on their bonus plans. Surprisingly, more than half of the respondents said they did not make any changes to their STI programs because of the economy. Those that did make changes reported diverse approaches.

The respondents provided their companies' approximate budgets for STIs as a percentage of operating income for 2010. As in the 2007

Figure 1 | LTI Plan Prevalence at Private Companies with an LTI Plan

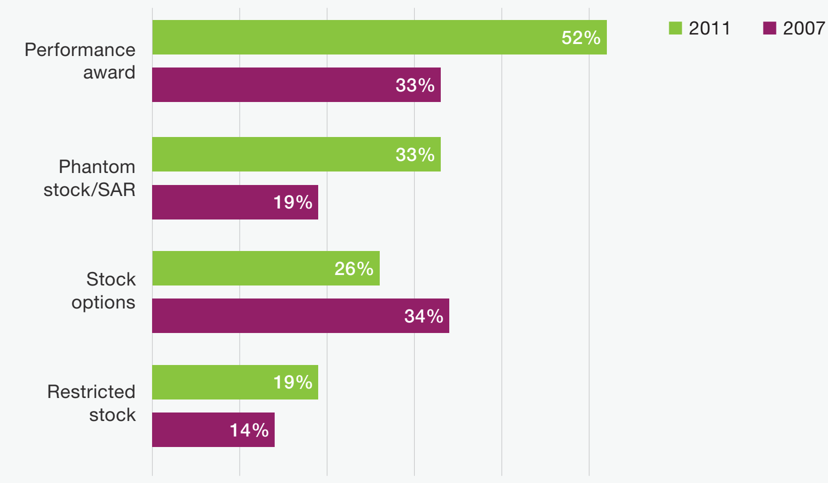


Figure 2 | 2011 Private Company Overhang

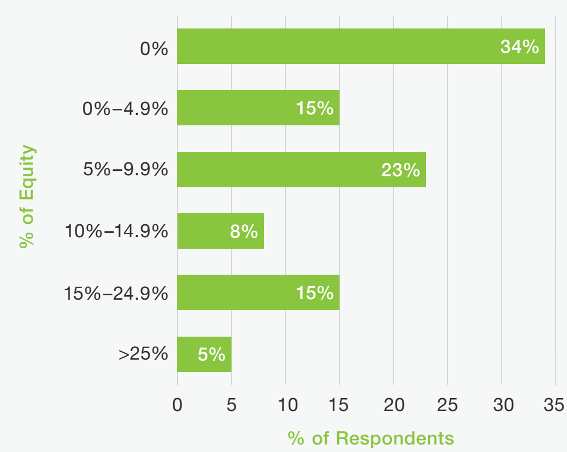


Figure 3 | Private Company LTI Valuation Mechanisms

	Stock Option	Restricted Stock	Phantom/SARs
Outside appraisal	65%	56%	35%
Formula	22%	38%	52%
Board discretion	4%	0%	10%
Other	9%	6%	3%

Figure 4 | Private Company Stock Option and Restricted Stock Liquidity Mechanisms

	Stock Option	Restricted Stock
At value-realizing event	65%	38%
At employee termination	44%	63%
Periodic trading sessions	22%	50%
Other	9%	6%

The consistency in company STI budgets indicates that employees' STI payments were reduced in line with any decrease in operating income because of the recession, but that incentive dollars were not diverted to other organizational uses.

Figure 5 | STI Plan Prevalence at Private Companies with an STI Plan

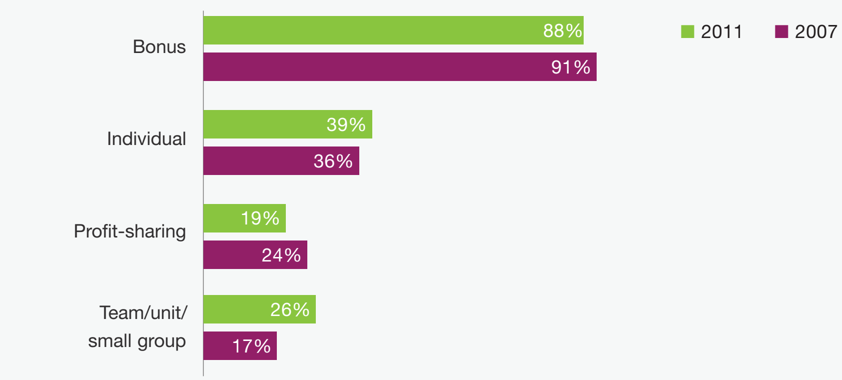
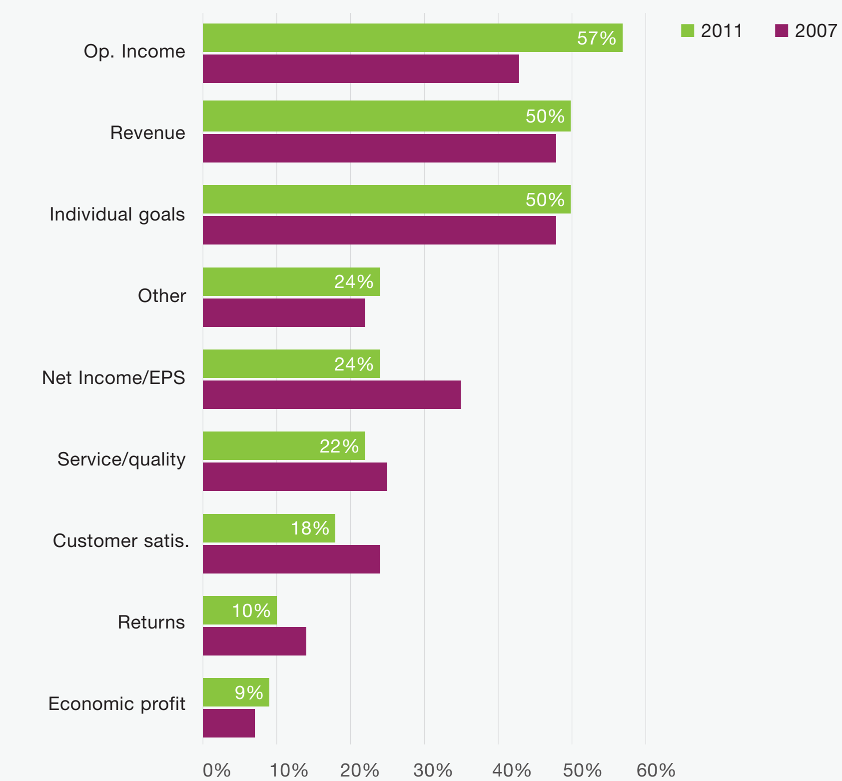


Figure 6 | Private Company Bonus Measures



survey, 2010 STI budgets ranged from 2 percent of operating income at the 25th percentile to 12 percent at the 75th percentile, with 6 percent being the median. The budgets were fairly consistent across companies of different revenue sizes. Respondents also provided their projected 2011 bonus budgets as a percentage of operating income. The 25th percentile moved up to 3 percent, but the median and 75th percentile stayed at 6 percent and 12 percent, respectively. The consistency in company STI budgets indicates that employees' STI payments were reduced in line with any decrease in operating income because of the recession, but that incentive dollars were not diverted to other organizational uses. About half of the respondents with bonus plans fund their plans using a pool that is established at the corporate level based on financial and/or strategic goals.

Bonuses are the most popular type of STI plan. About nine out of 10 respondents with an STI plan have a bonus plan. The prevalence of bonus plans and individual incentive plans stayed fairly constant from 2007 to 2011. The prevalence of profit-sharing plans decreased, while more respondents report using team/unit/small group incentives in 2011 than in 2007. (See Figure 5.)

Survey participants were asked what percentage of different employee groups received each type of STI award in 2010. Respondents report that bonuses and individual incentives are awarded most frequently to executives and management. Profit-sharing is used evenly across different employee groups. Team/unit/small group incentives are awarded on a limited basis evenly across different employee groups.

Bonus Plans

Since bonus plans are the most popular type of STI plan, the survey asked a number of questions about bonus plan design. Respondents were asked to report on the primary objectives of their bonus plans. The most common objectives reported in 2011 were the same as in 2007:

- Reward employees (74 percent)
- Focus employees on specific goals (67 percent)
- Share the organization's financial success with employees (55 percent).

Survey participants were asked which bonus plan performance measures they use. In 2007, revenue was the most commonly used measure. In 2011, operating income moved into first place, indicating an emphasis on profitability over growth because of the recession. (See Figure 6.)

Bonus plan performance targets at private companies are typically based on budgets and improvement over prior year. In 2011, two out of three private companies report that their bonus plans use subjectivity in bonus decisions.

The vast majority of respondents pay bonuses to employees on an annual basis. Bonus plan caps have become more prevalent since 2007. Nearly 70 percent of survey respondents report using a cap, up from about 50 percent in 2007.

Nonprofit and Government Organizations

Surprisingly, eight out of 10 nonprofit and government organizations offer some sort of STI program. Not surprisingly, only two out of 10 offer an LTI program.

The most common STI programs offered are bonuses and individual incentives. Bonuses are most commonly used to focus employees on specific goals (78 percent) and reward employees (65 percent), and the performance measures used tend to be more qualitative than financial in nature.

A minority of nonprofits offers an LTI plan. Deferred compensation is most common, while long-term cash plans are used by about half of the organizations with an LTI plan.

Conclusion

The majority of private companies now offer LTI plans for top executives in an effort to compete for management talent with public and private peers. Private companies favor cash-based LTI plans, such as performance awards and phantom stock/SARS, over restricted stock and stock options. For private companies, cash-denominated LTI plans are less complex, and less costly to design and administer than plans based on real equity. STIs are offered by nearly all private companies, with bonuses being the most popular type of short-term plan offered. Private companies appear to be aiming to narrow the compensation gap with their public peers. Future developments will be worth watching.

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