PRIVATIZATION TRANSACTIONS: COMPENSATION CONSIDERATIONS

HUGESSEN CONSULTING

Authors: Emily Parsons & Andena Xhiku

Following a few years of high valuations and numerous initial public offerings ("IPOs"), 2023 saw a dwindling of IPO activity and many companies going private. In 2023, 19 publicly traded Canadian firms (worth ~$12.5 billion) went private, while only one company had an IPO on the TSX[1]. This increase in go-private transactions may continue as many public companies face challenging market environments.

Against this backdrop, **companies must consider the compensation implications of a privatization event** (here, we are specifically referring to a transaction where there is a buyout of the public shares). This article will focus on **decisions related to equity compensation for the executive team through the transaction**, using the following framework:

I. Privatization context

II. Treatment of outstanding equity awards

III. Considerations for transaction and go-forward equity awards

I. Privatization Context

As with all compensation matters, the first step is to understand the broader context to set the foundation for tailored and informed decisions. Below we outline key topics and questions:

Topic	Considerations
Company and Performance Context	• What are the circumstances that led to the privatization event? • How long has the company been public? • What is the financial performance of the public company? • Will the transaction be shareholder-led or management-led?
Pre- and Post-Privatization Corporate Structure	• What is the funding mechanism for the privatization event (e.g. leveraged buyout)? • What is the pre-privatization and anticipated post- privatization share ownership? • At this stage, may also consider whether there is an expectation that management will buy-in as part of the transaction (see Section II for more information) • What is the pre- and post-privatization equity value, share price and number of shares? • Will there be a future monetization event, and if so, what is the anticipated timing of that event? • Will the new private company qualify as a Canadian controlled private company ("CCPC")?
Governance Structure	• Will the existing Board of Directors remain? • What is the anticipated turnover of Directors? • What are the respective governance responsibilities of each party in the compensation decisions being made for executives?

[1] Take-Privates in Canada Outnumber IPOs, Wipe Billions off TSX as Market Treads Water, Financial Post, 2023.
Canadian M&A Outlook 2023, Torys, 2023.

II. Treatment of Outstanding Equity Awards

The next step is to understand the status of outstanding compensation awards for the executive team and determine the appropriate treatment. This includes gathering information, preparing a set of guiding principles, and assessing alternatives against those criteria.

Gather Information

Topic	Considerations
Performance Context	• What is the perception of the management team's performance over their tenure? • Is there a sense that pay and performance have been aligned?

Compensation Programs and Historic Equity Grants	• What were the compensation programs when the company was private and public?
	• What equity awards have been granted historically (i.e., what is the type of instrument, vesting status, and outstanding equity value)?
	  ◦ One helpful tool is a Tally Sheet, which illustrates an individual's current ownership, "walkaway" value, and potential payouts under various price scenarios
	• Which executives have participated in equity programs to date?
	• How often were prior awards granted, and how were they sized (i.e., annual grants or larger front-loaded awards)?
	  ◦ There is somewhat more pressure on the buyout price in a scenario where equity awards were granted less frequently. In an annual granting approach, there is a "smoothing" impact given grants were likely made in varying share price scenarios
	• What is the economic impact of the privatization for employees?
	  ◦ Specifically, is the privatization providing a significant equity compensation gain for management, or is the privatization in the context of significantly depressed share prices and limited economic upside for participants?

Executive Contracts and Equity Plan Texts	• What are the legal entitlements for each executive and the "default" equity treatment? ◦ In all cases, executive contracts and equity plans should be reviewed in conjunction with legal counsel to confirm entitlements

Develop Guiding Principles

Guiding principles may include:

- Alignment with monetization timeline, if applicable
- Alignment with strategic priorities for the organization post-transaction
- Desired "sharing" between shareholders and management
- Retention and talent planning objectives, including potential hires or management changeovers
- Focus on individual(s) that are viewed as critical to the success of the organization

> Awards that are underwater (i.e., out-of-the-money stock options) may still have attributable "value", given the remaining time in the instrument.

Assess Against Alternatives

Alternatives for consideration may include:

- Roll-over of equity into the new entity
- Payout of equity (which may include accelerated payout or payout of vested but outstanding awards)
- Cancellation of awards (though it will be important to understand the legal ramifications and whether this is feasible)

Note that a combination of alternatives may also be used.

> To the extent that performance-conditioned awards exist and are being paid out or rolled over, the company will need to consider what the appropriate performance assessment is (for payout) or performance metrics (for rollover).

III. Considerations for Transaction and Go-Forward Equity Awards

Once the treatment of outstanding equity is decided, the final part of the framework is determining the structure of any grants that will be granted at the time of the transaction, and as a newly private company:

Topic	Considerations

Ownership Structure	• Will there be new grants to management and / or management buy-in expectations?
	  ◦ Sometimes in a privatization event, there is a desire to grant new equity to management to align their interests with new shareholders
	  ◦ In leveraged buyout scenarios, there is often the assumption that management will buy-in, in return for the delivery of stock options
	• If executives have real ownership, will there be lock-in agreements with tag-along rights to align a sale with shareholder experience?

Award Size and Frequency	• How will new equity be sized?
	  ◦ "Bottom-up": Equity is granted as a percentage of salary on a grant-date fair value basis and includes a roll-up of compensation target for each individual
	  ◦ "Top-up": Equity is granted as a percentage of the available equity pool for each individual
	• Will new awards be segmented by participant?
	  ◦ I.e., Are there groups of individuals that are viewed as critical? What percentage of equity will be given to the CEO vs. other executives?
	• Will the new grant represent a front-loaded award (in lieu of future years grants) or part of the normal course annual grants?

Award Structure	• Will the go-forward equity awards be structured as:
	  ◦ Stock options (which may be CCPC stock options or standard stock options);
	  ◦ RSUs or shares (similarly, could be structured as CCPC or standard units);
	  ◦ Cash deferral;
	  ◦ Other?
	• What will the time-based vesting be for the new awards?
	• Will performance conditions be incorporated?
	  ◦ In the case of a leveraged buyout, it is common to see vesting tied to a monetization event for the new owner, and / or based on a target performance metric (i.e., IRR)

Conclusion

As companies contemplate whether they undertake a go-private transaction, they must also consider any associated compensation implications. Once there is alignment on the context and rationale for a privatization event, Boards can determine a set of guiding principles which will help determine the appropriate treatment for outstanding equity and go-forward equity awards.

To ensure you receive future articles, subscribe here.