Developing an Exemplary Compensation Philosophy to Support Organizational Growth

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Introductions

Bruce K. Benesh
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Executive Compensation Advisor

Bruce is an executive compensation advisor with more than 46 years of experience in all facets of compensation arrangements, including strategic and tax planning relating to compensation arrangements and in international human resource consulting. Currently Bruce is the Managing Principal at Benesh Consulting Group. Prior to this, Bruce was the national managing partner for Grant Thornton's Human Capital Services and Family Business Practice. He was also the partner-in-charge of Arthur Andersen's North American and Latin American Human Capital Practice and the Divisional President of a consulting practice for a publicly traded company.

Industry and Consulting experience

Bruce has broad consulting experience in many industries with companies ranging from closely held family businesses and family offices to multi-national corporations. His experience includes advising clients and executives on all aspects of strategic planning and compensation, benefits and human resource issues, including competitive total compensation arrangements for executives, change-of-control and severance arrangements, qualified pension, profit sharing and stock bonus plans, fiduciary and governance planning for ESOPs, life insurance planning, welfare benefit plans, nonqualified executive compensation arrangements, and employer-provided fringe benefits.

He also has extensive experience serving family offices, family-owned businesses, and privately held companies in the design, and implementation of long-term, equity-based incentive plans.

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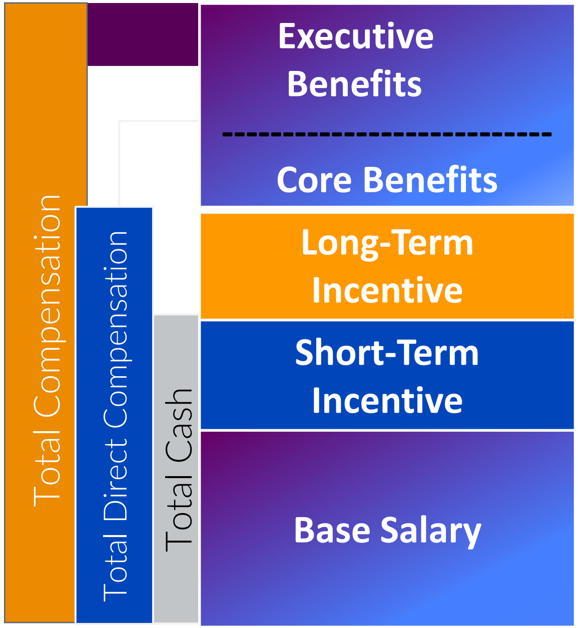
What’s on the Agenda

- Today we’ll be discussing various forms of compensation used by Family Offices (and families and referred so as such in this presentation) offices to attract, retain and motivate key talent
- How to align the compensation components with the goals of the family office and family in a “Win-Win” Way
- How to fit and build the right compensation components together in the optimum way to get the highest return on investment
- Explain how the compensation “pie” is changing for family office executives
- Explore the various ways of compensating family office/operating businesses executives to incentivize and retain them

What is the Compensation Philosophy of the Company, and Why Does it Matter?

- The "Nervous System"
- Great Philosophy = Top Talent "A+" People
- Poor Philosophy = The B or C Team
- Increasing return on compensation investment
- Compensation "pie" is shifting to more long-term opportunity
- 90% of executive "moves" require the family to implement a long-term plan

Customary & Market Competitive Compensation Components



- Company provided life and long-term disability
- Supplemental executive insurance and retirement plans

- Basic benefits competitively targeted against the market

- Total direct compensation
- Long-term incentive opportunity, typically covers 3 or more years
- Performance value sharing plan reviewed and approved annually

- Total cash compensation, calibrated to target market
- Annual performance based on quantitative and qualitative measures
- Short-term performance measures updated and reviewed annually

- Base salary (not generally at-risk for performance)
- Calibrated to target market based on job responsibilities and scope
- Generally, set at the 50th percentile or above

The overall goal is to have a "Win-Win" compensation program that is aligned with the owners and business strategy.

Definitions of Compensation Components

1. Competitive Base Salary:
Family offices need to offer competitive base salaries that are in line with market rates for similar roles in other industries, particularly financial services, real estate services, and wealth management.
Benchmarking compensation packages helps ensure that family offices attract and retain high-performing employees.

2. Performance-Based Incentives:
Performance-based bonuses, often discretionary, are a common way to reward employees for achieving specific financial targets or strategic objectives on an annual basis.

3. Long-term Incentives:
Such as equity participation, carried interest, or co-investment opportunities, can foster long-term commitment and align employee interests with the family's long-term goals.
Deferred compensation plans, considered an example of a Long-Term Incentive Plan can also incentivize employees to stay focused on the long-term success of the family office.

Common Pitfalls, Misimpressions, Indications of Future Issues Regarding Compensation

* Lack of alignment with company goals

* Insufficient market research leading to uncompetitive pay

* Ignoring internal equity

* Poor communication about the philosophy's goals and methods

* Failing to regularly review and adjust the philosophy as the company and market evolve

Note: Other mistakes involve focusing solely on base salary without considering the total rewards, neglecting performance-based pay, and not involving employees in the process.

Step One: Base Salary Review Scenario (Critical Step)

- Proper benchmarking is critical for establishing and administering compensation that is both competitive relative to the market and internally equitable
- A proper pricing process focuses on the content and scope of the job and not just on matching titles
- The analysis should reflect competitive market data from primarily family offices, but also utilize other correlated databases
  - For example, in this scenario, a family investment company with assets under management and invested (basically AUM) is a driver of market data for many roles from a size standpoint
  - For this example, an AUM of $250 million+ or the band of $250 to $499 million was used
  - Analysis of the data is normally presented at the 25th, 50th and 75th percentiles of the market for base salary, total cash compensation and total direct compensation (total direct is total cash plus any long-term incentive)
  - The benchmarking usually done for the top key executives for family office positions

Summary of Current Base Compensation in Scenario One

SUMMARY OF CURRENT BASE COMPENSATION
Current compensation reflects the following:

Base salary

- The following are the base salary amounts as of January 1, 2025

Other Incentive Plans

- The annual incentive amounts and any other long-term plan amount would also be shown

			Market Base Salary			Base % of Market		
Incumbent	Title	Base Salary	P25	P50	P75	P25	P50	P75
Mrs.	CEO/President	$525,000	$330,000	$417,000	$524,000	59%	26%	0%
Mr.	CIO	$400,000	$269,000	$319,000	$393,000	49%	25%	2%
			Average:			54%	26%	1%

Compensation Components Build the Philosophy for Family Businesses and Privately Held Companies

THE GUIDELINES FOR FAMILIES and PRIVATELY HELD COMPANIES DESIGN OF COMPENSATION COMPONENTS:

- Salary/total cash at 50^{th} + percentile
- Annual bonus program with goals
- Long-Term incentive plan (LTIP)
- Executives have “skin in the game”
- Compensation Philosophy weighting cash and LTIP

Goals and Purposes of Incentive Compensation as a Part of the Compensation Philosophy

- Creates additional focus
- Supports the strategic business plan
- Priorities are more clearly communicated
- Incentive compensation gives rallying “cry”
- Supports growing business partners
- Align important goals

A Compensation Philosophy that Passes the Quality and Governance Test

- Is the overall program equitable?
- Is the overall program defensible and perceived by the family owners as fair?
- Is the overall program fiscally sensitive (is it aligned with the performance of the company)?
- Can the organization effectively communicate the philosophy, policy and overall programs to owners and stand the “test” of time?
- Are the programs the organization for the family fair, competitive and in line with the compensation philosophy and policies (and especially support rewarding them competitively against the external market and internally fair)?

Incentive Plan Design and Trends

- Compensation Component Trends
- Annual Incentive Plans
- Long-Term Incentive Plans

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Establishing Goals and Performance Metrics for Annual Performance Bonus Plans

- Goals are measurable, realistic and attainable
- Performance measure levels
- Should reflect blend of overall performance
- Consistent weighting
- Payment of bonuses timely

Incentive Plan Design Principles

- Defined performance period and payment
- Threshold, target and maximum levels :
  - <u>Threshold performance</u> 80% of time
  - <u>Target performance</u> 50% of time
  - <u>Maximum performance</u> 20% of time
- Simple and understood
- Clearly linked to stakeholder’s goals
- “Well Communicated”

Annual Incentive Planning Step Two

OPPORTUNITY AND DESIRE

- Establish market competitive bonus
- Opportunity target say 50% of base
- Bonus as percentage of base salary
- Critical to cap: *"Absolutely Do This"*

Annual Incentive Plan Scenario Structure and Sample Metrics

Part 1: 50% based on individual/team goals

Part 2 : 50% based on operating results

- Weighting and average is a key part of a well-designed plan

Practical Application

Base Salary for 2025 and Bonus Opportunity

Salary	Threshold	Target	Maximum
$475,000	40%	50%	60%

Annual Bonus Plan Opportunity for COO Applied

- Bonus at threshold, target and maximum

Bonus Opportunity

2025		**Individual and Team Goals (50% of Bonus)**			**Investment Returns (50% of Bonus)**		
Participant	Base Salary ($)	Threshold	Target	Maximum	Threshold	Target	Maximum
COO	$475,000	Partially Meets %	Meets %	Exceeds %	8.50%	10%	11.50%
	$475,000	20%	25%	30%	60%	75%	90%

Long-Term Incentive Plan (LTIP) Overview

Goals and Purposes of Implementing LTIPS include:

Improve the competitiveness of compensation

- Align and incentivize the executives
- Serve as “golden handcuffs”
- Provide value creation-based compensation
- Executives share in the value created

Why Families Have Long-Term Incentive Plans as a Part of Compensation Strategy

The use of long-term incentives is an important component of compensation for family office executives and is a key component of having a competitive compensation structure as compared to the market.

Goals and Purposes of Implementing a LTIP Program:

Increase the competitiveness of total compensation levels and to "fill the gap" when a family office's total compensation arrangement is not competitive, or the family may not be reaching its stated compensation philosophy

Provide retention mechanisms using "golden retention incentives" (through vesting of LTIP opportunity, like a deferred compensation program)

Provide competitive compensation opportunities for executives in a tax efficient and flexible manner

Allow executives to build wealth through saving a part of their compensation that they have received and invest on a pre-tax basis over a period of years.

Using an Annual Grant LTIP

- **LTIP designed with Ultimate Level of Flexibility**
  - LTIP Contributions are determined and reviewed annually
  - Contributions determined separately by participant
  - The investment alternatives can be straightforward
  - Vesting can be separate for participants
  - Participants can enter the plan anytime

Considerations for Design: Compensation Structure Example

Compensation Component	CEO/President	COO	Private Equity Leader	Tax/Finance Directors
Base Salary	✓	✓	✓	✓
Discretionary Bonus				
Annual Incentive	✓	✓	✓	✓
Supplemental Deferred Compensation	✓	✓		
Co-Investment Opportunity	✓	✓	✓	
Carried Interest Participation	✓		✓	
Transaction Bonus	✓	✓		✓

Sample Long-Term Incentive Plan (LTIP) Design-Step 3

- Phantom Stock
- Carried Interest
- Supplemental Deferred
- Investment Opportunity
- Transaction Bonuses

Most Common LTIP Vehicles

Vehicle	Best Uses
Phantom Stock	-Family Offices with strong involvement in/oversight of family operating companies -Can be used for an array of participants-from one to many
Carried Interest	-Family offices with a private equity function -Participation usually limited to CIO/private equity roles
Supplemental Deferred Compensation	-Small family offices focused on managing family's affairs and investments -Single or limited participants
Investment Opportunity	-Family offices with a private equity function or similar investment opportunities -Participation should be limited to a select group of key employees
Transaction Bonuses	-Family offices with a private equity function -Current employees involved in transaction and in support/management of portfolio company

LTI Vehicles: Key Features

Vehicle	Key Features
	- Compensation based on increases in the value of the company/companies - Plans typically designed to provide ongoing value - Provide a good return on investment to the family - Must ensure adherence to 409A - Sense of ownership without giving up voting control - Can be used for an array of participants-from one to many
Carried Interest	- Designed as an incentive to maximize performance of an investment - Participants share in profits from the investment, once a return of capital and an agreed upon"hurdle rate" is achieved by investors - A participant's carried interest allocation, or "carry", may vest immediately or over time - Payouts typically occur upon a transaction - Carried interest allocations within a family office private equity function may be lower than the typical allocations at a private equity fund

LTI Vehicles: Key Features (Continued)

Vehicle	Key Features
Supplemental Deferred Compensation	-Simple to design and administer - Contribution can be determined as a function of annual incentives -Vesting may be pro-rata over time, or based on achievement of specific performance criteria -Investment returns fluctuate with family's -Must endure adherence to 409A

LTI Vehicles: Key Features (Continued)

Vehicle	Key Features
Supplemental Deferred Compensation	-Simple to design and administer - Contribution can be determined as a function of annual incentives -Vesting may be pro-rata over time, or based on achievement of specific performance criteria -Investment returns fluctuate with family's -Must endure adherence to 409A

Vehicle Key Features

Sample Long-Term Incentive Plan (LTIP) Design

- LTIP is an incentive deferred compensation plan
- Company makes an annual contribution to the plan
- Capital accumulation opportunity based on growth
- Amounts are shadow invested
- Cash is paid when fully vested.
- Liquidity element is important

How is it all Taxed?

EMPLOYEE

At Grant

- No compensation earned and no income taxation

At Payout/Receipt

- Payments taxed as ordinary income

EMPLOYER

At Grant

- No compensation paid and no income tax deduction

At Payout/Receipt

- Distributions tax deductible as paid to employee

Tandem Plan for Re-Deferral of Amounts Earned

- Tandem Plan alongside LTIP
- How it works and flexibility
- Used after fully vested in units and in payout status

Prepared for A Company 2025

Saving for Retirement and Using a Non-Qualified Plan

- Most executives cannot maximize 401k plan.
- Due to Internal Revenue Code rules
- Deferral plan can be the answer
- Making 401k like contributions
- Regular deferrals can be made
- Contributions to the deferred compensation “retirement” plan
- Amounts that are deferred are fully vested

Who Should Have a Change in Control Agreement and Other Considerations

Who should be included in a CIC agreement?

- Key employees, including the current top executives
- Other key employees who manage or control a substantial portion of Company's revenues, expenses, and assets
- Employees who will be essential to the transitional operation of the business as designated by the future owners (put in stay bonus at transaction if necessary)

Considerations for the Company and alignment of interests for all parties

- Generally, definition of a CIC should track the definitions in tax law provisions (more than 50% change of ownership)
- Double trigger CIC agreements are most popular, however single triggers can be used effectively in a number of situations
- Severance and medical benefits often range from 12- 24 months
- Major consideration and benefits could be a longer period of time than severance

Change in Control (CIC) Specifics Checklist

- ✓Single versus double trigger for cash severance to be paid under CIC
- ✓Definition of change of control (should match up in most cases to tax definition)
- ✓Base salary to be included in the calculation of severance
- ✓Annual bonus to be included in calculation and previous years target or actual bonus paid
- ✓Full vesting of any LTIP awards and using actual sales price as compared to formula in LTIP
- ✓Current year or year of transaction annual performance bonus is to be paid
- ✓Number of months that cash severance will be paid (generally range of 12 to 24 months)
- ✓Health and welfare benefits to be paid/continued and over the specified period of time (generally benefits are comprehensive and paid over same period of time as cash severance) i.e., number of months
- ✓Non-solicit and non-competition provisions in plan and how they should work

Compensation Committee Members Responsibilities Checklist

- Establish or recommend to the board all compensation elements for the CEO, and approve the compensation of other senior management members
- Fully understand all the costs of the compensation and benefit packages under a variety of circumstances.
- Prepare financial models of the various business scenarios to evaluate both upper and lower limits of the compensation to be paid
- Confidence that compensation is aligned with the interests of all stakeholders and support "Company's" corporate goals and strategies
- Evaluate whether the compensation programs reflects pay for performance and meets the return-on-investment threshold for A Company

Compensation Committee Members Responsibilities Checklist

- Establish meaningful targets for performance-based compensation and ensure that "Company" adheres to the goals
- Consider whether compensation plans support both short and mid-term "Company" objectives that will support meeting the long-term strategic plan
- Evaluate whether consideration has been given to a variety of performance-based financial and non-financial metrics, and whether those metrics for "Company" are balanced appropriately in the design of any incentive plans
- Address whether the current compensation programs support "Company" hiring the best talent and having the best team
- Engage and seek out the expertise of compensation consultants and other advisors who are independent and can support the compensation committee in performing their responsibilities at the highest level, with the highest level of governance for all parties

Long-Term Disability Review

- Inquire about the long-term disability policy in place

- If the company does not offer long-term disability coverage for any employees, this should be a key step

- Like the comments above regarding group term life insurance, a group long-term disability policy/coverage can be obtained at a very reasonable cost and can be a key benefit for an employee, and the company should review with their benefit insurance carrier

- Supplemental coverage should be reviewed as an opportunity to provide this very important benefit

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